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Commentary

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Abstract
Improving financial reporting calls for achieving a fine balance between codification of accounting rules, and development of norms whose enforcement depends on judgment about shared values and expectations in society. Over the past century, financial reporting has pursued codification in excess with unfortunate consequences. Development of mathematical finance and concomitant financial engineering makes written rules of accounting almost instantaneously obsolete through creation of new transactions and instruments. A more open system in which multiple standard setting bodies compete with one another to attract following among the preparer and user communities may help keep financial reporting useful.

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JEL classification: M41, M44

1. Balancing Statutory and Common Law Approaches

At least since the introduction of federal securities laws in the U.S. some eighty years ago, regulatory attempts to improve financial reporting have become increasingly focused on writing down the rules of accounting in ever-increasing detail. This codification or statutory approach to accounting regulation has marginalized the earlier dominance of a "common law" approach to accounting in which managers, accountants, and auditors used their best professional judgments to decide what to report, and how to report it. "True-and-fair" was the accounting equivalent of the "guilty-beyond-reasonable-doubt" standard still used by lay juries in courts of law to make life-and-death decisions. In pursuit of faux objectivity, accounting regulators around the world, including the U.S. and the European Union, have strayed after being persuaded that writing thousands of pages of rules by bureaucracies with monopoly power will serve us better. Nothing could be farther from the truth.

Unfortunately, there is little evidence that all these rules (mislabeled as standards for the sake of marketing them) have helped improve the quality of financial reporting. On the contrary, there is evidence that the standards written by the US and European bodies (the FASB and the IASB respectively) contributed to the recent global financial crisis at its roots. To consider two examples, replacement of lower-of-cost-or-market by mark-to-mark accounting (under comforting but misleading and impossible-to-criticize label of "fair" value accounting) reversed the traditional function of accounting to provide information for markets, and required them to be prepared on the basis of information from markets. With accounting simply reflecting what was happening in security markets, such accounting reports ceased to provide the markets with independent information, making the accounting-market system resemble a hall-of-mirrors, each side

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simply reflecting the another. The world economy has paid dearly for the resultant indeterminacy and instability in markets.

In a second example, rule makers allowed banks to delay recognition of losses on their loans until banks could identify the specific defaulters. They ignored the long-standing practice of recognizing certain amount of loss at origination of loans because, statistically, it is virtually certain that among the borrowers from any bank holding a large loan portfolio, a subset will default at some point of time. By delaying the recognition of loan losses, the rule-makers allowed banks to overstate their earnings, and to pay out handsome bonuses to their executives from never-be-realized profits.

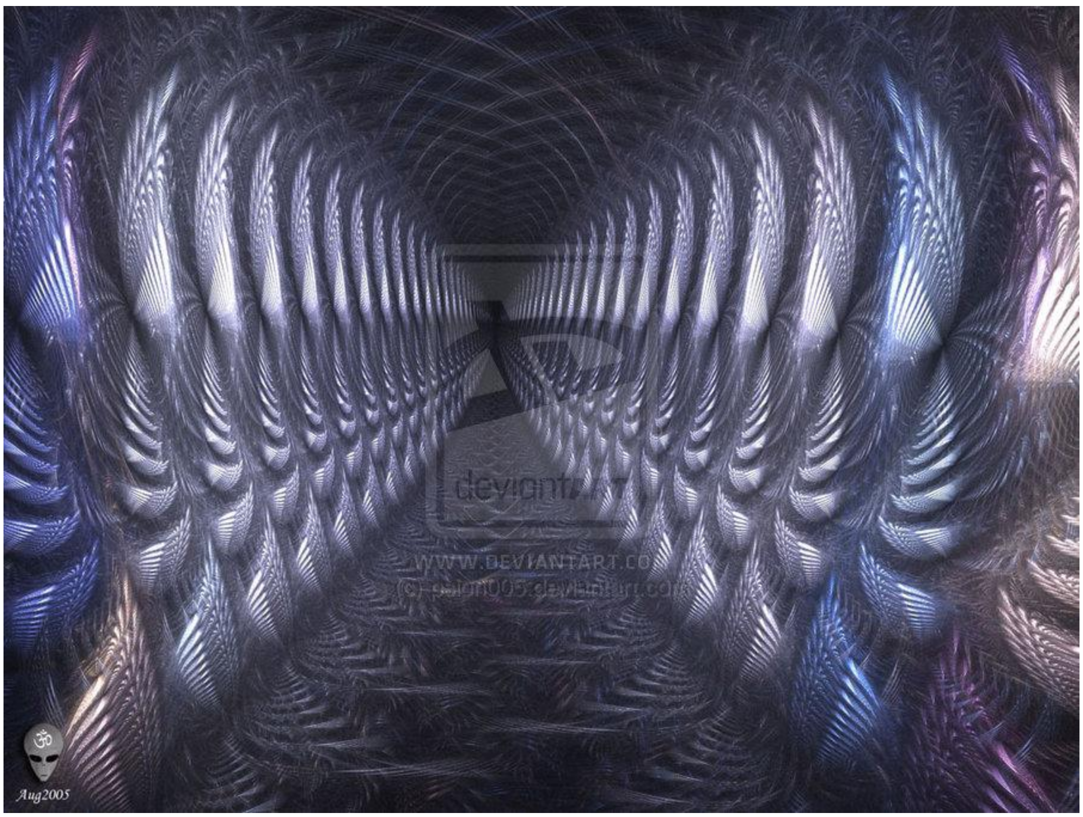

Figure 1. *Mirror, Mirror!*
Source: Dean Da Costa (2012)

A good financial reporting system requires a careful balance between an economical set of written general principles (think Ten Commandments, not IASB's 3,000+ pages of what they claim are "principles-based standards") and professional judgment guided by true-and-fair criterion. What is true-and-fair in financial reporting will be judged by common sense-based on considerations of equity; we already know, through experience of the recent decades, that writing out more details into the rulebook creates more loopholes than it closes.

2. Financial Engineering and Financial Reporting

Unlike most other industries, assets in financial services industry have no physical substance; they are defined by their accounting and covenants. This is true of shares of stock, bonds, and derivative securities. The specific combination of covenants and accounting features that define a security are designed by financial engineers (FE). FEs cohabit the world of financial reporting along with managers, bankers, traders, and accountants, and design the securities and transactions to achieve the goals of their clients. If the client is an investment banker, they may design a security so it is attractive to some class of buyers, but has sufficient complexity to allow the banker to market it for more than it is worth. If the client is a business corporation, they may design the security to help the corporation raise financing by concealing its increased leverage or risk exposure as reflected in its financial reports under the prevailing rules of accounting. In other words, a major if not the primary function of financial engineering is to manage appearances of financial reports with intent to mislead by evading financial regulations. In this sense, creativity in finance is no different from, or better than, creativity in accounting; the latter is often condemned, but the realization that the former has similar consequences is not yet as widespread.

Financial engineers have two advantages over accountants. First, accountants must do accounting for whatever transactions their clients choose to engage in; they have no say on their clients' choice of transactions. Financial engineers, on the other hand, have few constraints on what kinds of transactions they can create to serve their clients. Second, while accountants may take years of discussion and follow due process to write the rules of accounting for a given kind of transaction, it takes financial engineers little time—as little as days or hours—to design the transactions and securities that may serve their goals.

Massive expansion of written accounting rules over the recent decades (by the FASB as well as the IASB) has been driven by unwise and futile attempts by accounting regulators to fend off the creative innovations (read evasions) of financial engineers through increasing codification. Accountants do not appear to have realized that this strategy makes them sitting ducks for, and guaranteed losers to, financial engineers. Accountants foolishly respond to financial engineering "innovations" by writing more detailed rules to "clarify" the existing rules. Every clarification serves as a roadmap for evasion for the financial engineers because the additional detail makes it easier for them to design new securities and transactions to achieve their aims of frustrating the intent of accounting regulators. This is not a winnable game for accounting regulators. What could be an alternative strategy?

3. An Open, not a Closed System of Financial Reporting

Accounting regulators have fallen victim to financial engineering in a trap of their own making. How can they escape, and improve the quality of financial reporting? They allowed themselves to be persuaded by self-interested sweet talk about a "single set of high quality accounting standards enforced world-wide" improving the quality and comparability of financial reporting. What is "high quality" in standards remains undefined; and application of same standards across industries or countries with diverse legal, business, and economic environments does not enhance comparability. Yet, accounting regulators granted monopoly jurisdictions to FASB in the US and to IASB in EU. Then they proceeded to attempt a worldwide monopoly by agreeing to form a cartel and pursue a convergence project. This has been a disaster for three reasons.

Nobody knows, experts included, which proposed accounting rules would prove to be "good" or "bad", or even what their consequences would be when they are put in practice. Several decades of evidence on actions of the FASB and the IASB only confirms how little we know, and can know. The financial reporting, investment, market, and broader economic environment is simply too complex for even the best set of unbiased, selfless, hardworking people to accurately and reliably assess the consequences of new accounting regulations. Though a toaster is a far simpler mechanism, no manufacturer would dream of making and selling a new design without subjecting it to a field test. Even the U.S. Supreme Court tends to wait until alternative practices and interpretations have worked their way through experience and lower court decisions before agreeing to consider a case. Yet, the power of monopoly rights granted to them gave the FASB and IASB sufficient false confidence in their wisdom so they implemented and enforced many new accounting rules without any attempt to test them in the field, and without any evidence or experience on their consequences. The results of their missteps (see mark-to-market accounting above) contributed to the global financial crisis, and the world has paid dearly for them.

Evolution of a complex socio-economic system calls for learning from trial and error. Monopolies find it difficult to conduct such experiments, and to compare the consequences of alternative accounting regimes. Imagine a world in which all listed companies had to use the accounting rules written by a single body (e.g., IFRS). It would be impossible, in such a world, to find better accounting systems through research and comparison of alternatives. As economics tells us, most costly consequence of monopoly is loss of information available from competition. Absent competition, accounting too is essentially frozen, and unable to deal with the changing environment, and fast-moving financial engineering.

Increasing dependence of financial reporting on written rules hurts the scope for accountants' professional judgment. It has also shifted the focus of accounting education from analysis, thinking, and development of professional judgment towards greater emphasis on rote memorization of rapidly growing rulebooks. Subjects without intellectual challenge do not attract the best of students to accounting programs in universities.

Instead, it would make a lot more sense to create an open system for accounting regulation by each jurisdiction selecting two or more rule-making bodies whose standards are permitted to be used by entities in the jurisdiction. The US, for example, could permit (if it considered them appropriate) its companies to prepare their financial reports using accounting rules written by, say, the FASB, the IASB, and the Japanese rule-makers. Companies will be required to pay royalties to the body whose standards they use, and these royalties will be the sole source of their income. Rule-makers will receive no funding from governments, and will be monitored on an annual basis by the governments to assess which standards should be allowed in their jurisdiction.

Such a competitive arrangement for standards has the advantage of forcing the rule makers to balance the interests of investors, companies and the public. They will be induced to compare their rules with alternatives and adjust them to find a better balance between their detail and generality. Investors can be expected to flee from investment in companies who choose "cheap" standards, thus preventing a race to the bottom. Such regulatory competition is common in all parts of the world in education, insurance, corporate charters, stock exchanges, and environmental regulation. There is no reason why accountants cannot use a similar approach to escape the trap of financial engineering in which they have been caught by their pursuit of increasingly detailed written rules.

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