
Accounting is Exciting

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Common attitude towards accounting

- **ACCOUNTING IS BORING**
 - Attitude reflected in plays:
 - Charles Dickens' *A Christmas Carol* (1843)
 - Scene in the counting house
 - Mel Brooks' *The Producers* (1968)
 - Scene in the CPA firm
 - My personal experience
 - Starting as an audit clerk in Newcastle, 1960

Attitude periodically changes

- *The Producers*
 - Max Bialystock (an aging & failing producer) is having his books audited by a nerdy audit clerk, Leo Bloom
 - Leo figures Max can make money from Max's plays' failures
 - The two find a play they think cannot possibly succeed
 - Springtime for Hitler: A Gay Romp with Adolf & Eva at Berchtesgaden
 - They sell interests for 25,000 percent of the play
 - To rich old ladies whom Max romances
 - Unfortunately for Max & Leo the play succeeds
 - Leo & a nubile Scandinavian female assistant flee to Brazil
 - Taking the proceeds with them
 - Leaving Max to pay the piper

Moral of the Producers?

- Accounting is Exciting
 - Because it can be used to mislead

Examples of US Excitement

- 1929 NY Stock market crash
 - Accounting blamed for many “frauds”
- Frauds in early 2000s (e.g., Enron & WorldCom)
 - Accounting use of fair value versus verifiable MV or HC
 - Enron & Blockbuster
 - Bid-Ask Spreads
 - Instant earnings derivatives

Examples of US Excitement

- Sub-prime mortgage securities market crisis (2007-08)
 - Problem due to
 - Poor corporate governance
 - Accounting exacerbated problem
 - Banks
 - adopted FV accounting in 2007
 - used unverifiable FV to delay loss recognition until losses large & CEO fired

Casual evidence of increased accounting excitement today

- Articles on accounting & financial reporting in newspapers and financial magazines
 - Accounting conversations at
 - Cocktail parties
 - Golf club
 - Whenever someone finds out you are an accounting professor
 - Increase in Harvard undergraduates taking MIT accounting courses
 - Increase in professional accounting masters programs
 - Number of people who know who Arthur Andersen was
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Excitement Generates a Reaction

- Legislative
 - 1929 Crash led to Securities Acts & financial reporting regulation
 - Enron & WorldCom led to SOX & regulation of internal control
 - Sub-prime crisis will generate new US regulation for banks
- Legal System
 - Litigation
 - Big increase following Enron, WorldCom etc frauds (class action suits - **over**statements)
 - Lawsuits likely on sub-prime issues
 - Criminal prosecution
 - Enron, WorldCom
 - Sub-prime managers for **over**valuation of securities

Reaction to Excitement

- Regulatory - SEC
 - In the 1930's informally banned asset **write-ups** to market
 - Revenue recognition SAB101 (1999)
 - 2 advisory committees suggest moratorium on FV standards (2007)
- Regulatory - PCAOB
 - Ramanna & Watts (2007, 2008) goodwill impairments studies
 - Managers of poorly performing firms whose goodwill was very likely impaired used unverifiable FV valuations to avoid goodwill impairment
 - December, 2007, the PCAOB rebuked audit firms for not questioning management's goodwill impairment FV assumptions

Reaction to Excitement

- Regulatory - FASB
 - Previously tried to reduce performance over & expense understatements
 - Pooling
 - Despite danger to its health
 - Employee stock options
 - No apparent reaction to FV manipulations
 - FV≠MV, Sub-prime, SFAS 142 impairment
 - Continuation of FV program
 - Why?
 - Standards being turned over to IASB
 - Commitment to FV
 - Rewriting conceptual framework to justify FV
 - “The train has left the station”
 - Other
 - We will return to this question later

Reasons Excitement will Continue

- FASB & IASB commitment to FV
 - Unverifiable measures will create misleading reporting
- IFRS lack of allowance for economic & political forces

Fundamental Problem for FV & IFRS

- Efficient functioning of a country's capital markets depends on the country's combination of institutions
 - Financial reporting
 - Corporate governance
 - Financing methods
 - Legal system
 - Regulatory system
 - Political system
 - Tax system
- The packages of institutions evolve in response to economic & political forces to fit together like a jigsaw puzzle

Fundamental Problem for FV & IFRS

- Compare German & US capital markets pre-IFRS
 - Financing methods
 - Germany - more relationship banking
 - US - more open markets - more demand for public financial reporting
 - Corporate governance systems
 - German banks represented equity holders on firms' boards & received information
 - US equity holders use public reporting system for information for governance purposes
 - Tax systems
 - German taxes more directly affected by reported numbers than US taxes
 - Legal systems
 - US class action suits increase the conservatism of US financial reporting
 - Regulatory & political systems
 - US systems more open to the public generating more conservative reporting

Fundamental Problem For FV & IFRS

- Each jigsaw puzzle
 - Is different
 - Changes over time
- Relative success of jigsaw puzzles varies over time
 - In 1913 France (a code law country) had much more developed equity markets than the US (a common law country)
 - Rajan & Zingales (JFE, 2003)

Fundamental Problem with FV & IFRS

- When you change one jigsaw puzzle piece:
 - Sometimes the other pieces change
 - SOX may have caused US markets to lose cross-listings
 - But, the large increase in foreign investment in US private equity swamps any such effect
 - Zingales (JAR,2008)
 - Private equity does not have to meet US reporting standards
 - Other times they do not & the new jigsaw puzzle piece has to be changed
- This is the problem for
 - FASB with FV
 - IASB with IFRS

FV's Conflict with US Institutions

- US institutions cause US financial reporting to be conservative
 - Conservatism
 - is the application of a higher standard of verification for recognition of a gain than for recognition of a loss
 - that produces an understatement of a firm's net assets
 - Evidence conservatism exists is overwhelming
 - Guay & Verrecchia (2007)
 - FV is intentionally unverifiable
 - $FV \neq MV$
 - Levels 2 & 3 are unverifiable
 - FASB believes management will use discretion given by unverifiability to provide inside information to investors
 - Question is whether the institutions or FV will dominate
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FV's Conflict with US Institutions

- US institutions & markets inducing conservative reporting
 - Debt contracting - Watts & Zimmerman (1986)
 - Corporate governance - LaFond & Watts (2008), LaFond & Roychowdhury (2008)
 - Legal system - Watts (1993)
 - Regulatory & political systems - Watts & Zimmerman (1978)
 - Tax system - Watts (2003)
- All explanations have conservatism reducing moral hazard & agency costs
- Question is whether management's desire to provide information will dominate agency issues
 - Seems highly unlikely (Enron, WorldCom, sub-prime)

FV's Conflict with US Institutions

- Evidence on the competing hypotheses
 - Agency theory & evidence suggest management will use the discretion to mislead
 - Ramanna & Watts (2008) directly test the alternative hypotheses using goodwill impairments under SFAS 142
 - Strong evidence for agency theory; no evidence for FASB position
- These results & the institutional effects strongly imply FV will create more misleading financial statements & excitement
 - FV (as we know it) is unlikely to be kept as an effective financial reporting method
 - Excitement will generate a reaction

IFRS's conflict with institutions

- Wide variation in institutional arrangements across countries
- IFRS cannot be very constraining & still fit all institutional arrangements
- There is no world government to force countries to
 - Change their institutional arrangements
 - Enforce IFRS in a uniform fashion
 - Example: Japanese Ministry of Finance & deferred taxes - Skinner (2008)
- IFRS in practice will vary widely across countries
 - Ernst & Young (2006)
- This in turn will generate more excitement about accounting

Interesting Question

- Why is the FASB pushing a method that is unlikely to succeed (Value relevance - VR)?
- Tentative answer
 - Unlike other regulatory bodies the FASB has no institutional history of economic & political analysis (theoretical or empirical) of
 - Financial reporting
 - How financial reporting fits with other institutional arrangements

Lack of economic & political analysis

- When FASB began (1972) there was little analysis of
 - Economic reasons **existing** accounting methods were used; &
 - The economic & political effects of using different methods
- Further, profession was not prepared for such an analysis
 - Canberra, 1974
- Today I think the profession is prepared
 - London, 2005
- Further, there is now considerable analysis of how financial & regulatory institutions vary across countries
 - Law & finance literature, economic development literature

Original basis for determining standards

- From the 1940's through the 60's accountants sought a model for determining appropriate accounting methods for standard-setting
- Of necessity they had to rely on personal experience & observation of the selection of accounting methods
- The concepts they developed were descriptive of accounting practice, but were not positive economic theory
- This was the accounting "theory" studied by undergraduate accounting majors in the early 60's
- It was also the accounting "theory" early FASB members learned & used
- Standards based on that "theory" were not likely to be as disruptive as FV

What changed FASB such that FV evolved?

- Late 1990s-present
 - Some members with non traditional FASB backgrounds
 - Valuation experts
 - Academics
 - Trained post paradigm shift
 - Little exposure to practice or
 - If exposed to practice, did not receive academic training in the role of agency costs
 - Value-relevance literature
 - Ignored fact that financial reporting is only part of information market
 - Ignored effect of agency problems on accounting & financial reporting
 - Small dedicated group believed accounting valued the firm
 - Currently rewriting Conceptual Framework to produce VR prescriptions

Effect of Excitement on FASB

- FASB nature already starting to change
 - Since SOX FASB financed by taxes & answers to SEC
 - SEC
 - Makes mistakes but understands economic & political consequences
 - Criticized for lack of action in subprime case
 - Tends to act conservatively
 - Is starting to reel in the FASB
- However, until SEC understands FV & IFRS issues better, accounting will still be exciting

Lesson for Accounting Researchers

- My objective was to convey the
 - Excitement occurring in accounting practice &
 - Exciting prospects for accounting research as we study it in a much broader context
- Accounting research is already respected by finance researchers & is becoming respected by leading law & economics researchers
- The title of the talk should have been:

**TODAY ACCOUNTING PRACTICE &
RESEARCH ARE EXCITING**
