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How did Financial Reporting Contribute to the Financial Crisis?

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changes in market risk variables, and implementing a risk-equivalence approach to enable investors to understand better the leverage inherent in derivatives. We also conclude that because the objectives of bank regulation and financial reporting differ, changes in financial reporting needed to improve transparency of information provided to the capital markets likely will not be identical to changes in bank regulations needed to strengthen the stability of the banking sector. We discuss how loan loss provisioning may have contributed to the Financial Crisis through its effects on procyclicality and on the effectiveness of market discipline. Accounting standard setters and bank regulators should find some common ground. However, it is the responsibility of bank regulators, not accounting standard setters, to ensure the stability of the financial system.

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Crisis, including a discussion of concerns raised by critics of fair value accounting.

In light of these claims, Section 133 of the Troubled Asset Relief Program required the US Securities and Exchange Commission to conduct a study of mark-to-market, that is, fair value accounting focusing, on financial institutions and to report its findings to Congress by the end of 2008. The report focuses on assessing the role the fair value accounting standard, Statement of Financial Accounting Standards No. 157 Fair Value Measurements, played in causing bank failures; the impact of standards – particularly those relating to fair value – issued by the Financial Accounting Standards Board (FASB) on the quality of financial information available to investors; the process used by the FASB in developing accounting standards; and the advisability and feasibility of modifications to such standards. The study concludes that the crisis was not precipitated by mark-to-market accounting (US Securities and Exchange Commission, 2008) and that the process the FASB uses in developing accounting standards is appropriate. See Section 3 for a discussion of these issues.

See, for example, Ryan (2008), US Securities and Exchange Commission (2008), Shaffer (2010) and Laux and Leuz (2010).

It is the responsibility of bank regulators and not accounting standard setters to determine whether the information in the capital markets is sufficient for market discipline to be an effective regulatory tool. For example, if information about risk and leverage … ontracts is of poor … ation to provide … ision.

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It is also important to note that criticisms of fair value are often raised by parties who have a stake in the outcome of standard setting decisions. An example outside the context of fair value is the opposition by managers of high-technology firms to the expensing of stock-based compensation. Dechow et al. (1996) report evidence consistent with the hypothesis that the opposition to the expensing of stock-based compensation arose because of top executives' concerns with public scrutiny of their compensation.

In a bank regulatory context, Barth et al. (1995) find that regulatory capital violations based on earnings that includes fair value gains and losses for investment securities help predict future historical cost regulatory capital violations incremental to historical cost regulatory capital violations.

A related criticism is the 'anomalous' earnings effect from the recognition of gains arising from decreases in the fair value of a bank's liabilities attributable to an increase in the bank's own credit risk or the price of credit. This criticism is particularly salient during periods of economic downturn, when credit risk increases systemically. As Barth et al. (2008) show, these gains are not anomalous. Rather, recognizing such effects in earnings simply reflects the economics of debt and equity values. Consistent with this, Barth et al. (2008) provide evidence that equity returns are less negative when credit risk increases for entities with more debt in the capital structure. Consistent with the observat … l induces earnings … earnings effects a … recognition of debt v…

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To gain a better perspective on the magnitude of the growth in the credit markets during the US housing boom, the ratio of household debt to Gross Domestic Product in the USA, which had been roughly stable at 80% of personal income until 1993, had risen to 120% in 2003 and to nearly 130% by mid-2006 (Reinhart and Rogoff, 2009). Relating to the bust, US household debt declined by $13.5 trillion in 2009, amounting to $43,874 per capita, with most of the reduction attributable to mortgage loan defaults ('Americans Pare Down Debt', Mark Whitehouse, Wall Street Journal, 12 March 2010).

Non-transparency of information about assets banks securitized is not the only cause of the housing boom. Although poor quality of information about securitized assets contributed to excessive lending practices that precipitated the housing bubble, there was plenty of blame to go around. Several factors contributed to the housing boom, including the availability of cheap credit arising from monetary policy decisions by the Federal Reserve Bank, Congressional mandates for Fannie Mae and Freddie Mac to expand lending to non-traditional borrowers from low-income groups, and the failure of credit rating agencies to issue credit ratings for banks that reflect appropriately the riskiness of bank loans and other assets transferred to the SPEs (Barth et al., 2009). See Acharya and Richardson (2009b) for an in-depth discussion of the causes of the housing boom and its relation to banking regulation and asset securitizations.

Requirements for sale accounting in IFRS are broadly similar to those in US GAAP.
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US bank regulators require disaggregation of some contracts by whether the bank is a buyer or a seller of the contract. For example, US banks must disclose to regulators the notional amounts for credit default swap contracts they have bought and sold. However, this disaggregation is not required for all derivatives, for example, futures contracts. In addition, even for derivatives for which such disaggregation is provided, as with financial statement disclosures, no information about counterparty risk is provided. Because AIG is not a bank but rather an insurance company, these additional requirements do not apply.

See Barth's summary of the then extant research on risk and financial reporting in Schrand and Elliott (1998).

As an illustration, in its disclosure relating to its Level 3 fair value estimates in its 2008 annual report, the Royal Bank of Scotland (RBS) discloses that the recognized fair value of its interest rate and commodity derivatives was £2.2 billion, and the increase and decrease in value associated with reasonably possible alternative assumptions were £0.13 billion. RBS also discloses that the recognized fair value of its credit derivatives was £8.0 billion, and the increase and decrease in value associated with reasonably possible alternative assumptions were £1.03 and £1.20 billion.

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How does total quality management influence the loan quality of the bank

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