

# **Accounting Magic and Witchcraft**

Philip H. Dybvig

Washington University in Saint Louis

AES 1

New York

August 9, 2024

## Fischer Black “Magic in Earnings”

At a conference at CMU in 2011:

- I asked what should earnings be (so I could model hedge accounting)
- Steve Huddart answer!  $\times 10 =$  a good estimate of the stock price
- probably comes from Fischer Black (citation below)
- analysts’ dream
- not designed for that, but earnings work pretty well

Black, Fischer, 1980, “The Magic in Earnings: Economic Earnings versus Accounting Earnings,” *Financial Analysts Journal* 36(6), 19–24.

## More magic

Peter Bauer (according to Thomas C. Schelling): “[T]he number of things that economists knew that were true, important, and not obvious, was no more than the fingers on one hand.”

Thomas C. Schelling: “[M]y candidates for Peter Bauer’s collection all have the characteristic that, while at first glance they are paradoxical, once understood they are seen as incapable of being false. These are what are sometimes called accounting identities.”

Schelling, Thomas C., 2016 (originally 1995), “What Do Economists Know?” *The American Economist* 61(1), 77-80.

see also McCloskey, Donald N., 1993, “Schelling’s Five Truths of Economics,” *Eastern Economic Journal* 19(1), 109-111.

(thanks to Pierre Liang)

## Schelling magic

Leading example: when money “goes into” a market for existing goods (e.g. shares in a firm), the same amount of money comes out as goes in (ignoring taxes and other frictions).

National income accounts have similar examples: using credit cards more does not reduce the savings rate. The cash just moves to someone else’s savings.

Banking: money supply is created by a system of banks holding fractional reserves.

Beyond Schelling, most data we use in economics and our starting point in modeling of firms both come from accounting.

Rick Antle: “[Confusion] starts with people calling ‘Assets = Liabilities + Equities’ an ‘equation.’ It is not—it is an identity.”

## Witchcraft

The audience of this talk understands better than I do the powerful witchcraft of abuses of accounting. Enron, WorldCom, Lehman, and AIG are good examples. (By the way, aren't the CEO and CFO responsible for accuracy of the books under threat of felony conviction? I don't think any officers of AIG went to jail in the wake of the 2008 crisis.) I assume some of these are more-or-less out-and-out frauds, and others are more subtle. For example, I think that Enron made clever use of the notion of entity as a subterfuge.

I am going to be talking about more modest spells. Some of my questions are going to be about the role of accountants. To what extent are accountants (including rulemakers) responsible for the abuse of the tools they provide?

## Should Accounting Be a Profession?

I have heard that in the early 1900s the job of an accountant (resp. auditor) was to produce (resp. certify) financial statements that accurately represented the economic condition of firms. Now they produce (resp. certify) financial statements conforming to GAAP. This sounds like a practical move (to reduce lawsuits), but also a big reduction in discretion. So, should auditors be professionals or technicians checking compliance with GAAP?

I think that some things that are problems in accounting do not fit well into the standard structure in accounting and may not work well if the task is confirming compliance with GAAP. For example, accountants do not have the correct information to make sure banks have written down their zombie loans.

Paul Berney: “Cash is cash and GAAP is crap.”

## Different Sorts of Audits?

Different types of audits for different problems not handled well by standard accounting?

- fraud audit (I have heard of this idea. Is it a thing?)
- risk audit (e.g. net exposure to interest rates)
- write-down audit (e.g. currently real estate losses)

All of these potential businesses seem prone to litigation risk.

For banks, these functions are handled (although not necessarily very well) by bank examiners, who are supposedly doing something different from just auditing the books. Basel-style standards are not a substitute and may give a false sense of safety.

Joel Demski: Absent information asymmetry, accounting isn't needed.

## A Problem with Hedge Accounting

Given current hedge accounting standards, firms that hedge prudently probably look riskier than firms that do not hedge at all. I think the reason for this is that the standards are designed to be stingy about granting special treatment for hedges, or else it would be easy for firms gambling with derivatives to look safe. Ideally, the accounting treatment would make safe firms look safe and risky firms look risky, but accountants do not have the information needed to distinguish the two types of firms.

Dybvig, Philip H., Pierre Jinghong Liang, and William J. Marshall, 2013 “The New Risk Management: The Good, the Bad, and the Ugly,” *Federal Reserve Bank of St. Louis Review* 95(4).

(The same examples worked in the 1997 and 2013 versions.)

## Why hedge?

- risk sharing
  - who best bears which risk
  - conflict among shareholders
  - contract incentives versus constraints
- smoothing
  - cash flows? earnings? value?
  - how far out?
  - how to measure benefits?
- tax stories
- efficiency of compensation

## Accounting issues

- fair value hedge vs. cash flow hedge vs. unqualified
- income statement?
- balance sheet?
- 80/125 rule, correlation?
- AOCI (Accumulated Other Comprehensive Income)
- Cash flow hedge
  - hedge specific items or groups of related items
  - unrelated counterparty
  - hedge specific types of things
    - \* prices (but not quantities)
    - \* interest rate risk or FX risk
    - \* credit risk

## A wishlist (empirical and theoretical)

- Price and quantity data (instead of price times quantity)
- Aggregate wealth measures that make sense for land (need total not marginal value)
- Impossibility results for what accounting cannot do
- Exploration of Chapter 1 (desiderata of accounting rules)
- Accounting for scenarios (run/no run for a bank)
- Better understanding why footnotes are not a substitute for information in the body of financial statements.

## Going forward

- I'm happy that accounting theory is flourishing and no longer has the bunker mentality it had in the old days.
- This Society can help improve communications.
- There are a lot of interesting fundamental issues to think about.

Pingyang Gao: "What is missing is a dialogue between accountants and economists."