Undermining financial regulation

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President Trump set an example during his time in office. He “drove out” the Head of the Consumer Finance Protection Bureau (CFPB), Mr Cordray, and nominated Mr Mulvaney as the new Head[1]. Mr Mulvaney’s attitude to regulation was well known. He had called the CFPB “a sick joke”, and said he wished it didn’t exist.

In the UK in May, the Conservative City minister complained about the stringent rules and penalties imposed by the independent Payment Systems Regulator (PSR) to force banks to reimburse certain fraud victims (currently losing about half a billion pounds a year[2]). The PSR head promptly resigned. In August, new Labour Chancellor Reeves demanded that this and other financial regulators give more weight to promoting growth and competitiveness relative to consumer protection[3]. The compensation to be paid by banks was slashed.

In July, the rules for companies listing on the Stock Exchange were watered down, reducing required disclosures to shareholders, and weakening the voting power of external shareholders[4].

In August, the former chief economist of the Bank of England, Andy Haldane, derided IFRS, the International Financial Reporting Standards set for listed companies’ accounts by the International Accounting Standards Board (IASB): ‘IFRS may not be among the finest inventions of the human mind’[5], he jibed.

Haldane’s proposition

Haldane maintains that ‘after controlling for other factors, the switch [by EU countries] to IFRS accounting rules is found to have damped business investment by between a third and a quarter…’, and ‘added to EU carbon emissions by around 15-30 percent per year…’ And for the UK, ‘business investment has been materially lower, relative to GDP, than in the US’ where, he contends, the regulator ‘maintained a historic cost focus’, while IFRS, he asserted, ‘had a much stronger basis in fair value’ [up to date market values of assets and liabilities].

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[1] https://www.washingtonpost.com/news/business/wp/2017/11/24/the-cfpb-now-has-two-acting-directors-and-nobody-knows-which-one-should-lead-the-federal-agency/?noredirect=on&utm_term=.b77a17c69896

[2] Parker, G., Arnold, M, Quinio, A. and O’Dwyer, M., Scam reimbursement payouts to be slashed after pressure from fintechs, Financial Times, 4 September 2024 https://www.ft.com/content/5a09cf24-2ef2-48ba-9c85-f4c1c2e8598f

[3] Parker, G., Quinio, A. and Ring, S., Reeves queries watchdogs’ agenda, Financial Times, 13 August 2024 https://www.ft.com/content/dfab371b-17b6-41cf-bc9a-4cbdaed0bfe9

[4] O’Dwyer, M., UK announces biggest overhaul of listing rules in decades, Financial Times, 11 July 2024 https://www.ft.com/content/a990dfd6-ef99-40ca-b382-276f9f811d00

[5] Haldane, A., Blessed are the bean counters – except when it comes to growth, Financial Times, 5 August 2024 https://www.ft.com/content/2543a652-3313-45f2-81c8-627a31fc3c1a

He suggests the UK consider – Brexit-like – withdrawing from the IASB regime in order to make UK accounts – on his understanding - more favourable to business investment.

The new UK government has made increasing investment a dominant objective in the pursuit of growth and decarbonization. Securing the extra investment without government spending, just by changing accounting rules, is a very seductive proposition. And it comes from a distinguished economist highly experienced in policy-making.

However, the basic premises of Haldane's case – underlying the statistical work he relies on[6] – are of a very wide gulf currently between EU and US standards in relation to valuation, and a dramatic system change in EU standards in 2005. Neither corresponds with the facts.

There are many significant counter examples. For instance, it was in 2001 that the US, in accounting for vast sums expended on acquisitions, prevented acquirers from valuing the target's assets at historic cost ('merger' or 'pooling' accounting), replacing this with fair value of the purchase consideration. The UK had taken the same step for most cases since 1994[7]. And again, Haldane directs particular fire at fair-valuing pension fund liabilities - but UK and international standards had adopted fair value well ahead of 2005[8]. They reasoned that both investors and pensioners needed to know whether a company had set aside enough funds to meet its obligations. Many hadn't.

Determining exactly how far IASB or American FASB standards are more reliant on fair value, and how the valuation rules for different assets and liabilities changed over time would require a close study of many thousands of pages of standards. It is understandable that the economist Haldane was not aware of this. I have consulted former Board members of the IASB, who conjecture that, overall, America's FASB probably relied more heavily than IASB on fair value.

Not only are the premises of his case flawed. So is the statistical evidence he cites. For example, he makes bold claims about the differences between US and European investment behaviour, but the work he cites includes no direct tests of such differences. Moreover, he neglects to mention more robust independent published studies of the impact of IFRS, which conclude that these international standards have <u>increased</u> market liquidity and <u>decreased</u> the cost of capital[9] - facilitating the finance of company investment and GDP growth.

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[6] Haldane, A., Migliavacca, A. and Palea, V., Is accounting a matter for bookkeepers only? The effects of IFRS adoption on the financialisation of the economy? Cambridge Journal of Economics, Vol. 48, 2024

[7] https://www.routledge.com/Accounting-for-MA-Uses-and-Abuses-of-Accounting-in-Monitoring-and-Promoting-Merger/Amel-Zadeh-Meeks/p/book/9780367492373?srsltid=AfmBOooB81KZVXgDyn_-lSmbWbXjuQAe2xHjqWU9H4EttjH5q3q3hESO

[8] Tweedie, D., Cook, A., and Whittington, G., The UK Accounting Standards Board, 1990-2000: Restoring Honesty and Trust in Accounting, Routledge, 2024, chapter 8.
https://www.routledge.com/The-UK-Accounting-Standards-Board-1990-2000-Restoring-Honesty-and-Trust-in-Accounting/Tweedie-Cook-Whittington/p/book/9781032388168?srsltid=AfmBOooE_VnHEZIADReaqO42LeBMCcpiLitmfm0OUIzRtt8pgWmYSD_p

[9] Barth, M., Landsman, w., and Lang, M. , International accounting standards and accounting quality, Journal of Accounting Research, 2008

Li, S., Does mandatory reporting of IFRS in the EU reduce the cost of capital? The Accounting Review, 2010.

Previous experience of accounting regulation

As Haldane asks us to return to accounting standards based on obsolete data, it's worth recalling how they actually worked. UK company accounts in 1990 'were a laughing stock', wrote The Times[10]. Leading analyst Terry Smith's 1992 book reported that '…much of the apparent growth in profits which had occurred in the 1980s was the result of accounting sleight of hand'[11]. (He was fired from his City job for pointing this out).

In the 1990s, the newly independent and strengthened UK Accounting Standards Board (ASB), led by Sir David Tweedie,[12] introduced a more rigorous regime, incorporating some fair valuation, and between 1994 and 2000, inward portfolio investment in UK equities – funding business expansion - recorded a twenty-fold increase[13].

This is consistent with modern information economics. Nobel Laureate George Akerlof wrote about asymmetric information in markets generally: 'The purchaser's problem…is to identify quality. The presence of people in the market who are willing to offer inferior goods tends to drive the market out of existence[14]. Baruch Lev applies the argument to the equities market; 'At the extreme, suspecting gross information asymmetries, uninformed investors may quite rationally withdraw from trading…altogether…'[15]

Return to weaker national standards?

Haldane raises the possibility of the UK adopting purely national standards, 'unencumbered by EU Directives'. But this flies in the face of thirty years of efforts by the international, American and UK standard-setters to harmonise rules and better inform cross-border funding of investment. European standard-setters were collaborating and converging with the Americans

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Daske, H., Hail, L., Leuz, C. and Verdi, R., Mandatory IFRS reporting around the world: early evidence on the economic consequences,

https://doi.org/10.1111/j.1475-679X.2008.00306.x

[10] *Sergeant, G. (1997), No news is good news for Sir David, The Times, 4 December 1997*

[11] Smith, T. (1992) Accounting for growth: stripping the camouflage from company accounts, first edition, London: Century

[12] Tweedie et al, op. cit., chapter 10.

[13] Meeks,G. (2003) Reporting to shareholders: the proposals in the Company Law Review, Journal of Corporate Law Studies, 3(1), pp.191-200

[14] https://www.sas.upenn.edu/~hfang/teaching/socialinsurance/readings/fudan_hsbc/Akerlof70(2.1).pdf

[15] Lev, B. (1988) Toward a theory of equitable and efficient accounting policy, Accounting Review, 63, 1-22.

through the 1990s[16]. The IASB was set up in 2000, with strong financial and technical support from the US and with American members much the biggest national group on the Board.

The example of Daimler Benz illustrates the motivation. The first German company to list on the New York Stock Exchange, it had to report its income using US accounting conventions, alongside the German ones it had been employing. The German figure for 1993 was a surplus of DM615mn; the US figure was a loss of DM1,839mn[17].

When the London Stock Exchange earlier this year proposed watering down local regulation, reducing required disclosures to shareholders, and weakening the voting power of external shareholders, the regulator, the Financial Conduct Authority, reported that 'investors have been "overwhelmingly against"' these planned changes[18]. UK business relies heavily on investment funding from abroad (by 2020, 56% of the value of the UK Stock Market was held in the rest of the world)[19]; and a manager of the world's biggest sovereign wealth fund has argued that the Stock Exchange reforms 'would result in weaker investor protection and could harm the UK's reputation as a market with high corporate governance standards'.[20]

The same could be said of Haldane's proposal to replace an independent body of experts, mandated to meet the information needs of international investors, with idiosyncratic national standard setters incorporating obsolete data and under the thumb of Treasury politicians.

Appendix

Haldane's misunderstanding of past and current accounting standards alone invalidates his statistical inferences and policy prescription. But even if he were right about the standards, the design of his tests and choice of measures are questionable in relation to his policy proposals.

Research design

The thrust of Haldane's case then is that if European companies followed US (supposedly historic cost based) accounting rules, their investment rates would be closer to the higher rates enjoyed by the US. Curiously, the evidence he cites from his own research[21] does not directly compare European corporate investment behaviour with American (I can find no mention of the

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[16] Tweedie et al 2024, op. cit., chapter 9.

[17] Nobes, C. (1997) German accounting explained: reducing the barriers to measuring company performance in Europe's largest economy, London: FT Finance, Pearson Professional

[18] O'Dwyer, M., UK announces biggest overhaul of listing rules in decades, Financial Times, 11 July 2024 https://www.ft.com/content/a990dfd6-ef99-40ca-b382-276f9f811d00

[19] ONS, Ownership of UK quoted shares, 2020 https://www.ons.gov.uk/economy/investmentspensionsandtrusts/bulletins/ownershipofukquotedshares/2020

[20] Agnew, H. Global investors warn UK on overhaul of listing rules, Financial Times, 9 February 2024 https://www.ft.com/content/b4c1551c-a28f-4ae3-bfe4-705f34a15f0c

[21] Haldane, A., Migliavacca, A. and Palea, V., Is accounting a matter for bookkeepers only? The effects of IFRS adoption on the financialisation of the economy? Cambridge Journal of Economics, Vol. 48, 2024

US in that study). A conventional way of 'controlling for other factors' to make his case would be a contemporaneous comparison of investment by US and European companies, or of EU companies governed by IFRS and European companies not so governed. But instead he does a 'before and after' 2005 comparison of European companies subject to IFRS.

Unfortunately, 'controlling for other factors' for a 'before and after' comparison in this case is extraordinarily challenging. The whole climate for investment was transformed soon after 2005 by the financial crash. Frozen markets for credit, recession, and austerity brought an end to previous years' 'NICE' (non-inflationary constant expansion). It took almost eight years for UK real GDP per head to recover to the level of 2007 – an even weaker recovery than was achieved in the Great Depression[22]. In his book *Crashed,* Adam Tooze even compares 2008 with 1914 as one of the turning points in Western history. Controlling for such other factors is hazardous to put it mildly.

Little wonder then that his investment model 'explains' so little of investment expenditure: R squared is only 20%.

Measuring investment

As well as the curious introduction of bold claims about US/UK comparisons, there are other 'disconnects' between Haldane's Financial Times article and the statistical paper Haldane cites which he wrote with co-authors Migliavacca and Palea. The latter is more cautious, and explores alternative models and measures. It makes passing mention of one measurement issue when comparing investment levels over time, but this is lost in Haldane's FT article.

in the UK, investment in intangible assets such as early stage R&D and investment in training (human capital) has grown relative to that in tangibles such as machinery and buildings, and now exceeds investment in tangibles[23]. But, as Haldane et al mention, this is hard to quantify in the company accounts they use for their study. Standard-setters are wary of companies flattering their profits by capitalizing ongoing expenses – not charging them against the current year's revenue. As a result, much of investment in internally-generated intangibles is not recorded as investment in company accounts. We can't tell how much of the claimed decline in European companies' investment expenditure is attributable to the trend shift from tangibles to intangibles, combined with the under-reporting of intangibles.

A second caveat concerning Haldane et al's investment measures is that some of them include spending on the acquisition of other companies. When the resulting numbers are used – as in Haldane's FT article – to generalize about investment to expand GDP and decarbonise the economy, there is a risk of committing a common fallacy of composition. Buying another company's assets represents investment and growth of capacity for the acquiring firm; but in itself it does not represent an expansion of capacity for the economy – the macroeconomic

[22] The Madison Project and the Conference Board, cited in:

Wolf, M. (2015) *The Shifts and the Shocks: What We've Learned—And Still Have To Learn—From The Financial Crisis*, London: Penguin.

[23]

https://www.ons.gov.uk/economy/economicoutputandproductivity/productivitymeasures/bulletins/investmentinintangibleassetsintheuk/2021 concept Haldane is implicitly using. This M&A 'spending' is just a reallocation of control over existing assets (and actually consumes resources in transaction costs)[24]. Yet for many businesses in the West, spending on M&A has even overtaken CAPEX (buying, maintaining, or improving fixed assets such as land, buildings or machines)[25].

[24] Meeks, G. and Meeks, J.G. The Merger Mystery, 2022, Open Book Publishers, https://www.openbookpublishers.com/books/10.11647/obp.0309
[25] Amel-Zadeh, A. and Meeks, G., eds., Accounting for M&A: Uses and Abuses of Accounting in Monitoring and Promoting Merger, Routledge, 2020