Funding the Future

Unless we make balance sheets reflect reality then fina...

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In sum, Congress should mandate that companies report all of their assets and liabilities. Companies that omit material assets and liabilities from their balance sheets should be subject to civil liability in the same way companies generally have been exposed to private rights of action for material misstatements. This is not a radical proposition: it is precisely what Congress did in 1933 and 1934, in response to that era's financial crisis.

At first blush, the off-balance sheet problem might seem unfathomably complicated, and perhaps that is why some people in government did not include reforms directed at this problem as part of the "Plan A" approach to financial reform. But average people understand what liabilities are, and they know what can happen if people are permitted to lie about their debts. Market capitalism requires transparency, or it will not function properly. That is not a controversial proposition. And it is why requiring disclosure of off-balance sheet transactions is a crucial part of "Plan B."

It only takes a few simple questions for the average person to understand how much trouble off-balance sheet accounting can cause. Here are a few: What if the next time you wanted to borrow money you didn't have to list most of your debts? What if Congress let you keep your credit card bills and mortgage liabilities hidden from view? If you could hide your debts, how much would you borrow? What would you do with that borrowed money? How much risk would you take? The answers do not require knowledge of rocket science. Common sense tells us that if we let people hide their debts, they will borrow more than they should, at the wrong times, for the wrong reasons.

Simply put, our biggest banks have been hiding their debts. Even after the recent crisis, they continue to hide them, now more than ever. Most people and business include all of their liabilities on their financial statements. Banks *should, too.*

Then note what one of the authors had to say in the FT today:

[T]he [Goldman Sachs]case demonstrates a more effective way to police bankers, because Wall Street cannot outrun a judge. That simple point has been part of Anglo-American common law jurisprudence for centuries. The US judge Oliver Wendell Holmes advised that the law was a prediction about what a judge would do. If bankers consider only whether they are complying with specific legal rules, they will create "alegal" transactions — deals that fit the letter of the law but violate its spirit. But they cannot be certain about how a judge might assess their conduct. That worry, not a rule, is what will make bankers tell clients about the presence of a fox.

What he's suggesting is a General Anti-Avoidance Principle for accounting. And as he then argues:

More generally, the suit against Goldman gives Congress a way forward for financial reforms. For example, the credit rating agencies, which rated Abacus 2007-AC1 triple A, were not named as defendants. Nor was Paulson, which issued a statement denying wrongdoing. These are important omissions, especially that of the rating agencies, which should worry about what a judge may say. Congress could ensure that they will by eliminating the protections that have shielded them from liability.

Congress could also use the threat of litigation to reform derivatives and off-balance sheet transactions. As currently drafted, the new law would do nothing about recently publicised accounting abuses at Lehman Brothers and other banks. The banks' inaccurate financial statements have generated howls of protest but no successful litigation.

Lynn Turner, the former SEC chief accountant, and I have published a paper explaining how Congress could reform this area with one simple paragraph requiring that financial statements reflect reality.*

The reality he asks for is this:

* Companies must include swaps on their balance sheets.

* Companies must record all assets and liabilities of Variable Interest Entities (VIEs), in amounts based on the most likely outcome given current information.

* Companies must report asset financings on the balance sheet (not as "sales").

* Congress should adopt a legislative standard requiring such disclosures (mere "guidance" from the accounting industry is not enough).

* Companies that fail to disclose material facts should face civil liability.

Of course it may not be enough by itself to stop all abuse - country-by-country reporting would help that too — but it would help massively.

Assume the combined might of the accounting, legal and banking professions will be opposed — as they are to country-by-country reporting.

Which is precisely why we need such reform.

These guys are the abusers.

They are the fraudsters in he sense that they use deceit to secure advantage — even if the deceit is not illegal at present. .

They are the people who need to be brought to book.

Now.