Book Reviews

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In The End of Alchemy former Governor of the Bank of England Mervyn King examines the role of money and banking in the 2007–2008 financial crisis and asks the question, “How did this happen?” (p. 1). He analyzes the forces that resulted in the financial crisis and asks whether it was a failure of individuals, institutions, or ideas. King argues that most accounts of the financial crisis focus on the “symptoms of the crisis,” such as the rise and fall of housing markets or bad lending decisions by banks, rather than on the “underlying causes of the events that overwhelmed the economies of the industrialised world in 2008” (p. 26). He further argues that we will be unable to understand what happened or prevent a repetition unless we focus on the underlying causes rather than the symptoms. Although he does not directly address the role of accounting, his discussion of what went wrong and his framework for financial reform is highly relevant to the debate regarding the role of accounting in the financial crisis and post-crisis accounting reforms that rely on the same way of thinking that King argues made the crisis more probable.

Rather than blaming institutions or individual policy-makers or bankers for the crisis, King states that the crisis was “a failure of a system and the ideas that underpinned it” (p. 3). He argues there are fundamental weaknesses in the intellectual economic framework that are important in understanding what happened. Specifically, he criticizes the mathematical models that rely on the “idea that rational individuals would lead the economy to an efficient equilibrium” (p. 12) while saying nothing about the importance of money and banking. He notes that “the paradox of money is that people choose to own something that has no intrinsic value, and pays no interest” (p. 59) and that “money in the form of private banknotes and deposits is a claim on illiquid assets with an uncertain value” (p. 60). He argues that the mathematical economic models that ignore money and banking ignore important concepts and “lose site of the informal analysis of disequilibrium, radical uncertainty and trust as a solution to the prisoner’s dilemma” (p. 12).

King argues that “the economic path on which the world economy was proceeding was clearly unsustainable” (p. 40) and the crisis does not represent a temporary deviation from the steady equilibrium growth path, but instead reflects a disequilibrium as the global economy transitions to a new equilibrium path. In his view, “the crisis was not so much a financial earthquake, releasing pressure that had been built up, as a sudden shift to a lower path than seemed normal only a short time earlier” (p. 42). The primary evidence that he provides in support of this claim is the slow economic recovery after the financial crisis despite “the biggest monetary stimulus the world has ever seen” (p. 44). The resulting fall in the real interest rates encouraged increased consumption and investment. “Households and businesses came to believe that levels of domestic demand were sustainable” (p. 319). If his supposition is correct, then attempts to use monetary and fiscal policy to “speed up the return to the underlying path of steady growth” (p. 45) are doomed to fail. This alternative view of a stable but unsustainable path also seems relevant to concerns about the cyclical effects of accounting and policies designed to reduce accounting-induced procyclicality.

The concept of radical uncertainty, which King defines as “uncertainty so profound that it is impossible to represent the future in terms of a knowable and exhaustive list of outcomes to which we can attach probabilities” (p. 9) has important implications for the validity of accounting measurements. King states that “at the heart of modern macroeconomics is the same illusion that uncertainty can be confined to the mathematical manipulation of known probabilities,” (p. 121) but argues that “there is an inherent problem in linking a known present with an unknowable future” (p. 11). He supports his argument by
noting that financial crises, although thought to result from an unexpected realization of low-probability events, actually occur fairly frequently. Rather than being caused by realizations from probability distributions with “fat tails,” relatively frequent, sudden, and large changes in asset value might instead be explained by radical uncertainty. King further argues that the need for money and credit arises from radical uncertainty and is unnecessary when uncertainty about the future can be reduced to a known probability distribution. He states “the consequence of radical uncertainty is the coordination problem that creates the possibility of boom and slump” (p. 302) and is subject to the prisoner’s dilemma. His claim that “despite the repeated inability of economic forecasting models to predict accurately, there is a persistent belief that there is, if only we could find it, a ‘model’ of the economy that will produce forecasts that are exactly right” (p. 122) is also relevant to understanding the role of accounting during the financial crisis and especially to the accounting policy changes designed to reduce the procyclical effects of accounting.

In contrast to the views expressed by King, the Financial Crisis Advisory Group, which was formed by the FASB and IASB to provide advice on improving accounting standards, argued that financial reporting could have helped provide more transparency to either help anticipate the crisis or respond to the crisis more quickly and could have helped identify issues of concern. Similarly, the Financial Stability Forum, which was founded by the G7 to promote international financial stability, identified bank provisioning practices as one of the three priorities for policy action in 2008, and their 2009 report that addressed these policies noted that earlier recognition of loan losses could have dampened cyclical moves in the current crisis. In response to the recommendations of these two advisory groups, the FASB has modified loan loss provision accounting, requiring an estimate of expected credit losses over the life of the asset. The FASB summarizes the measurement of expected credit losses as “based on relevant information about past events, including historical conditions, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount.” These recommendations and the FASB’s response to them implicitly assume we know what we do not know and can assign probabilities to expected future losses based on past experience.

The FASB’s expected credit loss model reflects the economic thinking of rational actors and equilibrium paths. If, instead, the financial crisis reflects disequilibrium and a movement to a new equilibrium path, then historical and current information will not be relevant in predicting future losses. If the financial crisis is the product of radical uncertainty as described by King, where “no one can easily predict an unknowable future” (p. 3), then he would argue that reasonable supportable forecasts are merely an illusion. King goes so far as to state that “radical uncertainty means that it is impossible to know how big might be the losses on loans” (p. 106), making it “rational to be concerned about whether a bank can make good its promise to return a deposit on demand” (p. 106). “The basic problem with the alchemy of the banking system is that it is irrational for one person to place trust in a bank if others do not” (p. 106).

The implications of King’s arguments go to the heart of the debate over the importance of provision accounting during the financial crisis. If, as he argues, “crises are the result of the unavoidable mistakes made by people struggling to cope with an unknowable future” (p. 12) and “if we don’t know what the future might hold, we don’t know, and there is no point pretending otherwise” (p. 131), then the move to an expected loss model from an incurred loss model will likely not be an improvement. In contrast, if the financial stability forum’s view that “management’s expert credit judgment” was not reflected under the incurred loss model and that the expected loss model will allow “all institutions to incorporate reasonable judgments regarding the impact of factors that are likely to cause loan losses to differ from historical levels,” then the move to an expected loss model may lessen the effects of future financial crises. The distinction between knowns that can be estimated probabilistically and radical uncertainty extend beyond the financial crisis and hold implications for accounting more generally.

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