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# The objectives of financial reporting

Speech by Hans Hoogervorst, Brussels 9 February 2011

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In the past three years, I have participated in many intense debates on accounting questions. Two questions have dominated these debates. The first question that always pops up, is to which audience financial reporting should primarily be directed: should they primarily be targeted towards investors, or should they address a more general public, including for example prudential regulators? A second, related question is whether accounting standards only serve the goal of transparency, or if they should also have a financial stability objective.

I was often puzzled by the intensity of these debates, given the fact that I think these questions can be answered in a fairly straightforward way.

Let us first try to answer the question to which audience financial reporting should primarily be directed.

Nobody will disagree that the purpose of financial reporting is to provide as faithful a picture as possible of the financial position of a company or organisation. Financial statements should contain information that is as unbiased and reliable as possible.

It goes without saying that financial statements are most relevant to the investor.  After all, financial reporting was born out of the necessity to give investors adequate information on company they are providing capital for.  The interest of the investor will always remain the main focus of accounting standard setting.

At the same time, it is important to realize that if the purpose of financial reporting is to be as faithful as possible, it is less relevant who the user of the financial statement is. If a financial statement of a company is as accurate as possible it cannot be accurate in 10 different ways. It could not possibly become more or less faithful depending on the question whether an investor, a depositor or a regulator is using it.

Moreover, while it remains undeniable that financial statements are of primary importance to investors, in our modern economy so many entities are working with “other people’s money” that financial reporting is of importance to much wider interests. High quality financial reporting is of essential importance to depositors and their protectors, the prudential regulators, to suppliers, to creditors in general.

Indeed, reliable financial reporting is such an important ingredient  for building trust in our global market economy, that it can be said to be of public interest. That is why the IFRS Foundation mentions in the first paragraph of its constitution that it works “in the public interest”.

It is hard to underestimate the public interest of IFRS. IFRS is already the common business language of well over 100 nations. It is indeed the only set of standards that has the potential to be used all over the world. IFRS is an engine for economic modernisation, linking industrialized nations with growth markets around the world. Only IFRS can unleash the full potential of a truly global capital market. It can make an enormous contribution to economic growth by enhancing transparency and liquidity around the world.  This is a global public interest which I will be proud to serve.

The second hotly debated question is the question whether the purpose of financial reporting should primarily be to provide transparency, or that it should also serve the goal of stability.

In this debate, transparency and stability are often juxtaposed as if they were conflicting goals. I think this is essentially a false contradiction. In my view, it is clear that transparency is a necessary precondition of stability. The current credit crisis has to a large extent been caused by a lack of transparency in the financial markets. Huge risks were allowed to build up on and off balance sheet without being noticed. Without proper transparency about risks, stability is bound to collapse in the end. Stability is not the same as transparency, but there can be no durable stability without transparency.

So accounting standards can contribute to stability by enhancing transparency. There are plenty of recent examples of how accounting standard setters are doing just that, often in close consultation with the prudential community. I am referring to the tightening up of conditions for off-balance sheet financing; the proposed convergence to eliminate differences between US GAAP and IFRS in the netting of financial assets and liabilities; the proposed introduction of the expected loss model to enhance loss recognition in the loan portfolio in a timely stage.

Accounting standards can also be useful for stability purposes by avoiding artificial noise in the balance sheet and the income statement. This was an important reason for the IASB to continue with a mixed attribute system with regards to financial instruments. Financial instruments that have basic loan features and which are managed on a contractual yield basis are valued at amortized cost. For such instruments, cost is deemed to provide more relevant information than short term market fluctuations. This method can indeed prevent unhelpful noise, yet it should not imply that market expectations are irrelevant, as I will explain later.

The distinction between the P&L and Other Comprehensive Income is another example of accounting standards being sensitive to preventing noise in the income statement. While the definition of OCI is in need of a firmer theoretical underpinning, it is a pragmatic way of shielding the P&L from volatility in the balance sheet that does not truly reflect the financial performance of the entity.

So accounting standards can make a very important contribution to stability by providing maximum transparency, and by avoiding artificial noise.

However it is important to keep this in perspective. Stability should be a <u>consequence</u> of greater transparency, rather than a primary goal of accounting standard-setters. For this, accounting standard setters simply lack the tools. For example, they cannot set capital requirements for the banking industry. This instrument belongs to the prudential regulators who <u>do</u> have stability as their main mission.

What accounting standard setters can also <u>not</u> do is to pretend that things are stable which are not. And, quite frankly, this is where their relationship with prudential regulators sometimes becomes testy. Accounting standard setters are sometimes suspicious that they are being asked to put a veneer of stability on instruments which are inherently volatile in value.

Whereas the search for transparency is the natural focus of accounting standard setters, this is not necessarily the case for prudential regulators. They are bound to strict confidentiality rules and often feel an understandable need to work out problems behind closed doors. After all, maximum transparency may not always be the best way to prevent a bank run.

More generally, transparency does not always come spontaneously to an industry that is as vulnerable as the financial sector. It is indeed hard to imagine a riskier business model than the current banking industry. Both sides of a bank's balance sheet are prone to volatility.  Its assets can be very sensitive to the economic cycle, whether they are based on derivatives, bricks and mortar or sovereign risk. Gold-plated triple A can turn sour very quickly, as we have seen in the case of Ireland. The banking industry's liability side is also notoriously vulnerable.  Funding can evaporate with the speed of a mouse-click.

As if this is not risky enough, the banking industry has been allowed to run on the flimsiest of capital margins. The capital cushion of the banking industry has been allowed to shrink dramatically in the last century. Just before the crisis, tangible common equity of most banks was lower than 2% and in many cases close to zero!

It is no surprise that this business model experiences recurrent crises all around the world. More than occasionally, banks need to be rescued by government intervention or massive budgetary stimulus.  Even more frequently, the financial industry needs to be propped up by free supply of raw material by central banks in the form of artificially low interest rates. The implicit or explicit government guarantees that many banks enjoy, allow them to borrow at rates that are in effect subsidized. In effect, the financial industry is among the most heavily state-supported sectors of the world economy.

Many weaknesses of the current system are being addressed. Capital requirements are being increased; underwriting standards are being improved; the infrastructure of the derivatives markets will be strengthened. But many vulnerabilities will remain. Even under Basel 3, triple-A sovereign risk carries zero risk weights, while we should know by now that zero risk does not exist. The new leverage ratio – while a great improvement in itself- will (at 3%) still be low in the light of the massive losses that were experienced during the current crisis.

One cannot envy the prudential authorities for being responsible for such an inherently unstable system. In these circumstances, it is also understandable that they can be uncomfortable with accounting rules that force problems into the open. It is only natural that banking supervisors try to buy time for the banking system to get back on its feet. It must also be admitted that in the past this approach has occasionally been effective. Paul Volcker – the greatest central banker of all time – still remembers with pride how by hiding the fact that the American banking sector was basically broken during the Latin American debt crisis, he created time for the banks to repair their balance sheets.

However, I sincerely doubt if this method still works in the 21st century. In these days of the information revolution on the internet, of intensely prying media, institutional investors and activist shareholders, it is an illusion that you can keep real problems hidden for very long. Indeed, a perception that regulators may not be transparent about the true nature of the problems may serve to fuel undue unrest in the market.

The July 2010 stress test of the European banking sector is a case in point. The markets immediately perceived this stress test as a lacking in rigor. One reason for scepticism was that sovereign bonds on the banking book were deemed to retain their full value, despite the fact that many were trading at steep discounts in the market. The fact that some Irish banks that had passed the test later turned out to be insolvent only served to reinforce the doubts in the market.

I also wonder what kind of message this stress test gave to auditors. The European Commission is asking questions about the fact that auditors gave clean bills of health to almost all the banks that failed during the credit crisis. But how critical will auditors be when they see that regulators consider that severely discounted securities carry no risk?

By the way, the introduction of an expected loss model is very high on the wish list of prudential regulators, to promote more timely recognition of losses. How credible can that be if currently obvious signals pointing at impairment are ignored?

The amortized cost model for banking book securities can only be credible when impairments are booked in a timely fashion.  If too wide a divergence between market valuations and the book value of such securities is maintained, ultimately investors will start clamouring for extension of fair value accounting.

The truth is that investors around the world have had little faith that the financial industry has been facing up to its problems in the past years. In such circumstances, markets often become suspicious and they tend to overreact. Thus, lack of transparency directly feeds into lack of stability.

There is one final reason why I think that both the accounting and prudential community should be fully committed to transparency. That reason is that preventing a crisis through full risk transparency is much less costly than letting things go and cleaning up afterwards. Should a clean-up be inevitable, time should not be bought by trying to hide problems, but by making  them manageable through better support and resolution mechanisms such as are currently being designed.

My career has been fully devoted to the public interest and I am strongly motivated to work closely with all stakeholders, including the prudential community for the common good. But while we cooperate, we should respect each other's mission and responsibilities.

Accounting standard setters should remain committed to their main goal of providing transparency. By providing transparency, they give a great contribution to stability. The difficult task of making the financial industry safer is the responsibility of the banking supervisors. I am convinced that they can strengthen their mandate of guarding stability by using more effectively transparency as a preventive instrument. The regular publication of rigorous stress test, such as mandated by the Dodd-Frank Act, can do a lot to help them in their difficult task of imposing adequate capital levels on the financial industry.

In the final part of my speech, I would like to make some observations about another sensitive issue, namely the relationship between independence and accountability in accounting standard setting.

When you look at the fundamentals of IFRS, it is striking that most of them are based on plain, economic sense. Despite its complexity, IFRS is actually a quite elegant system of economic reasoning, firmly rooted in common sense.

At the same time, we have to recognize that financial reporting is not an exact science. Asset valuation is in many respects more of an art than a science.  Many assets are not homogenous and they often have no active of liquid markets that give reliable price signals.  In many cases, asset valuation requires a lot of judgement and/or common sense. Often there is room for legitimate differences in opinion.

But often, accounting disputes are not fed by genuine intellectual debates, but by naked financial interests. It was not in the interest of CEO's to run share based payments through the P&L. That is why they fought it tooth and nail when accounting standards were forcing them to do so.

It was also not in pleasant for companies to have their pension liabilities fully visible on their balance sheet and therefore IAS19 on employee benefits met fierce resistance. Though these changes forced changes in some business practices, it is clear that they were for the good, bringing hidden costs or liabilities out into the open.

Accounting standard setting should therefore be sensitive to legitimate business concerns but be firm and independent in the face of special interests. Independence is an essential precondition for durable public trust in accounting standard setting.

At the same time, I fully realize that independence does not come automatically. The IASB should never be perceived as an Ivory Tower. Independence will only be respected if there is a strong sense of ownership among the user community and among the public authorities that endorse the standards. This is a huge challenge, especially for a young organisation that has conquered so much territory in a very short time.

I see four ways to strengthen the worldwide sense of ownership of IFRS. First of all, the quality of the IASB's standards should always be first-rate. We may have differences of opinion about content; the quality of the IASB's work should always be beyond doubt.

Secondly, we need a first-rate system of due process. The IASB already follows very strict rules for due process in which exhaustive consultation takes place around the world. The IASB's deliberations and voting procedures are broadcast live on the internet, making it one of the most transparent standard setters in the world. Still, we need to build on existing outreach efforts to ensure that participants around the world are heard and their views given due consideration by the Board. The opening of a regional office in Japan is an important step in that direction.

Thirdly, the IFRS-foundation needs to be fully aware of the challenges that can be involved in the implementation of the standards. While standards need to adapt to rapid economic developments, in the timing of changes we need to take into account the user's capacity to digest them.

Finally, independence needs to be accompanied by a strong system of accountability. The governance of the IFRS Foundation is now being reviewed by the Foundation itself and by the Monitoring Board. I believe the governance of their relationship can be strengthened and I look forward to proposals to that effect. It is very important that we develop a governance structure that is more inclusive and in which all jurisdictions using IFRS feel adequately represented.

At all costs we should avoid the impression that the IFRS Foundation is dominated by a small group of countries. As a global organization, I feel it is very important that all participants have a sense of ownership. Obviously it is a huge challenge to make a homogenous body of a young, international organisation. Throughout my career in public services I have met many challenges. I even enjoy them. So I am very much looking forward to chairing the IASB in the coming years.