Arnold Schilder: Accounting standards, transparency and supervision

Speech by Professor Arnold Schilder, Executive Director of De Nederlandsche Bank NV, Board Member of the Pensions and Insurance Supervisory Authority of the Netherlands, and Chairman of the Accounting Task Force of the Basel Committee on Banking Supervision, at the congress EYe on Banking, sponsored by Ernst & Young, in Utrecht, 6 November 2002.

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Introduction

Frequent downward restatements of earnings, and accounting abuses, have deeply shaken public confidence in the reliability of financial reporting. This has contributed to the worldwide downfalls in share prices. In this context, questions arise such as what should be done with accounting standards and whether greater transparency could help to restore public confidence. Also, what role supervisors can play in this respect. I will discuss these issues from both an accounting and a supervisory perspective.

First, let me put the erosion of public confidence in financial reporting into its proper perspective. In some countries, particularly the US with Enron, Global Crossing and Worldcom, confidence has waned more than elsewhere. But this was not the only cause of the current malaise on international financial markets. In this respect, the correction of the asset price bubble, the weakening of macro-economic prospects and the threat of war in the Middle-East have been substantial factors as well. Also, incentive structures within firms and in financial markets may have been distorted. Excessive attention to share prices coupled with disregard for long term fundamentals, and exuberant stock option programmes are cases in point. With hindsight, it is fair to say that apart from failures in accounting, there have been shortcomings in disciplining mechanisms, such as in corporate governance, in auditing and in disclosure, as well.

Accounting standards

What can be done to restore confidence in financial reporting? On a global level, the International Accounting Standards Board (IASB) is working hard to deliver a set of high quality standards as soon as possible. But it is not easy. Why? The first complication is the increasing difficulty of proper measurement. Take, for instance, the growing importance of intangible and non-marketable assets, such as intellectual property rights or goodwill. Another example is the valuation of long-term flows of income or expenditure, such as pension liabilities, which are inherently difficult to predict. In addition, complex instruments for risk transfer and new corporate structures test the limits of existing measurement and valuation techniques. In essence, accounting standards have to be frequently adapted in response to developments in corporate practices and financial markets. These are moving targets!

The second issue is the fundamental dilemma in the formulation of accounting standards, namely having to choose between rules-based and principles-based standards, in other words between detailed standards or standards in more general terms. Rules-based standards, like the US Generally Accepted Accounting Principles, in principle may be easier to enforce. However, they increasingly bear the risk of being circumvented, either through financial innovation and engineering, or through what has been euphemistically called ‘aggressive accounting’. Principles-based standards, like the International Accounting Standards, or in the new jargon the International Financial Reporting Standards, may allow for financial innovation more easily. At the same time, they may leave more room for interpretation and thus may be more difficult to enforce. But this issue is not as black-and-white as it seems. On the one hand, there are US attempts to move closer to principles-based accounting. A study on this subject has been mandated by the recent Sarbanes-Oxley Act. Principles-based standards, on the other hand, will most likely retain rule-like components as well, particularly in order to create accounting discipline for complex issues such as financial instruments. This explains, for example, the complaints about the new IAS 39 Exposure Draft being too prescriptive. Moreover, principles-based accounting will not obviate the pressure to make the principles more precise, easier to enforce, and hence, more rule-like. If so, this may give rise to differences between countries and hence raise questions of international coherence. In other words, principles-based accounting creates level playing field issues.

A third subject is fair value accounting for the recognition and measurement of financial instruments. Fair value accounting has potential advantages. Essentially, the increased use of market-based information may enhance the transparency and comparability of financial statements. However, fair value accounting may not yet be feasible and reliable ‘across the board’, and may lead to an artificial volatility of financial results. This greater volatility in turn, if not properly explained and understood, may negatively affect public confidence. For these reasons, it seems sensible for the time being to focus on expanded fair value information in the Notes to the Financial Statements.

This brings me to a fourth point of interest, the need for risk accounting. Traditionally, accounting has concentrated on the information contained in the balance sheet, income and cash flow statements. Arguably, this is no longer sufficient to determine what risks are being run by firms, particularly firms active in financial markets. Modern financial instruments and techniques, such as derivatives or securitisation, enable them to change their risk profile, sometimes even at very short notice. So more information should be provided about a firm’s risks. That is why banking and insurance regulators encourage disclosures by financial institutions on risk exposures as a means of enhancing market discipline. The IASB is working hard on this as well.

Another issue is the context of accounting. International accounting standards mainly deal with financial measurement and disclosure. They do not extensively consider the setting in which financial reporting takes place, such as the firm’s corporate governance or risk management, the role of the audit committees or the internal and external auditors. Auditing standards, however, take a different approach. They first define the conditions to be met by the company environment, before describing what should be audited, and how this should be done. Interestingly, prudential authorities follow the same route. The Basel Committee’s guidelines, the Nederlandsche Bank’s Regulation on Organisation and Control or the Pensions and Insurance Supervisory Authority’s Principles on Internal Control start from the primary responsibility of the management and the directors for sound governance. They then elaborate the requirements to be met by these functions. So the question is whether international accounting standards should deal more comprehensively with the setting for accounting and reporting within the firm and address accounting governance more explicitly. Internal reporting procedures and compliance, an active role of the audit committee, a separation of responsibility for and financial interest in financial reports, for example, are most relevant for sound reporting. Perhaps accounting standard setters should no longer take them for granted. Without an appropriate environment of sound corporate governance and risk management, accounting standards resemble a safe car without a qualified driver!

In short, accounting standards need to be adapted to changes in corporate practices and financial markets. Modern standards should be principles-based, take account of sound corporate governance, and be risk-oriented. To get this across, there is a constructive dialogue between accounting standard setters, like IASB, and regulators, such as the Basel Committee on Banking Supervision. Although they have a different scope and different objectives, their interests clearly run parallel in many areas, for example in accounting for loans and proper provisioning practices, or in transparency about risk management. In these fields, the Basel Committee appreciates the dialogue with accounting standard setters and the industry in order to achieve sound and effective reporting. Topical issues are IAS 39/32 and IAS 30. A recent Roundtable in Basel, chaired by BIS General Manager Andrew Crockett, confirmed the need for a coordinated dialogue regarding corporate governance, accounting and auditing, and transparency and oversight.

Transparency and disclosure

Let us now turn to transparency. Transparency is a prerequisite for effective market discipline. In theory, the rationale for greater transparency is that companies, particularly financial institutions, present information asymmetries to the markets. Simply speaking any company is better informed about its own operations than outsiders are. If the company publishes more information to facilitate the assessment of its assets and liabilities, its strategies and risk profile, markets can function more effectively, at least in theory. Markets contain disciplinary mechanisms, which stimulate sound management and adequate financial performance. For companies which are well-run, well-financed, and transparent, costs of raising capital will tend to decline. The reverse goes for ill-managed firms. More generally, well-run firms, by being transparent, can obtain better terms and conditions in transactions with informed and rationally-behaving market counterparties. In essence, this is market discipline.

Market discipline, however, works only if market participants have sufficient information, which enables them to assess companies' activities and their inherent risks. But more disclosure as such does not necessarily result in greater transparency. On the contrary, rather than just expanding their disclosures, firms should pay attention to the quality of information as well. In short, information disclosure needs to be timely, reliable, relevant and sufficient. Importantly, public disclosure of high quality information contributes to corporate governance. That is to say, the information can be used to hold directors and managers accountable for their decisions and the firm's performance. Transparency, in other words, serves the accountability of companies to their stakeholders.

One aspect of public disclosure which should not be overlooked is the costs involved. Information is not a free good. On the contrary, developing, implementing and maintaining up to standard information systems is costly and takes time. For that reason, accounting standards, should, above all, require relevant information. However, there is a professional risk of an overdose of information, which must be heeded by both standards setters and regulators.

Pillar 3

Let me illustrate this by explaining the Basel Committee's efforts to increase transparency. Market discipline through enhanced public disclosure is one of the main three elements or 'pillars' of the new Capital Accord. That also goes for the new European capital adequacy directives. Pillar 3 recognises that market discipline has the potential to reinforce and support minimum capital standards (Pillar 1) and the supervisory review process (Pillar 2). This way, it helps to ensure that banks maintain appropriate levels of capital as a cushion against potential future losses arising from risk exposures. Pillar 3 contains proposals for greater disclosure by banks, pertaining to three broad categories, the so-termed scope of application of the Accord, a bank's capital adequacy, and its risk exposures and assessments. For essential elements of the new Capital Accord, such as the use of an internal ratings based approach (IRB), disclosures will even be required for supervisory recognition. This means that a supervisor is not supposed to recognize the use by a bank of these techniques, unless the bank has met the disclosure requirements. In this respect, in addition to Pillar 1 with its IRB, Pillar 3 marks the transition to a fundamentally new approach in prudential supervision.

As to the content of the information, Pillar 3 aims to provide for a comprehensive set of consistent and comparable disclosures. It should, in other words, establish a common framework for the information to be made available by banks, and that would allow a meaningful comparative analysis by recipients of that information. Comparability is greatly enhanced by the use of the risk weighting methodologies in the context of Pillar 1 as a common yardstick for the purpose of public disclosure. At the same time, however, Pillar 3 should not become overly prescriptive. That is why Pillar 3 attaches great importance to qualitative disclosures. This will allow a specific bank to explain and elaborate the particular characteristics of its operations in plain language.

An interesting dimension to the development of the Pillar 3 disclosures is the relationship vis-à-vis the accounting standards, and vis-à-vis listing requirements promulgated by securities regulators. As I have said before, the costs of public disclosures by banks should be limited. Therefore, banks may rely on disclosures under accounting or listing requirements insofar as these are materially equivalent to Pillar 3 requirements. However, such requirements have a broader focus than the third pillar, which aims at banks capital adequacy. Pillar 3, in other words, is a more specific interpretation of the general rules, as a reflection of its more precise objective. Supervisors are therefore keen on the on-going revision of the IASB disclosure standard for banks, IAS 30 and IAS 32. The Basel Committee maintains an ongoing relationship with the IAS 30 Advisory Group in order to achieve consistency between disclosure frameworks.

Supervision

I now turn to the last topic, supervision. We must not ignore that public disclosure has its limitations and potential drawbacks in certain circumstances, particularly in the financial sector. Modern banks' business is complex and opaque. This means that information asymmetries will be reduced, but not completely removed, even if public disclosure is enhanced. Therefore, it cannot be ruled out that market forces fail to instil sufficient discipline and that banks take excessive risks. When that happens, the market may react too little, too late. Once the risks start to materialize, and the market is aware that the bank's position is weakened, it may react excessively. Banks may then be subjected to high interest rates or ultimately be excluded from the market, possibly even regardless of their performance. This could spread to other banks and jeopardize the stability of the banking system.

Here, prudential supervision complements the picture. Although prudential supervision entails efficiency costs, it has additional advantages for banking stability, as compared to disclosure. Basically, supervisors pay due regard to systemic implications of banking problems, and act accordingly. Supervisors have a public responsibility to maintain systemic stability and to prevent an escalation of an imminent crisis. Such conduct can not be expected from banks' counterparties, who pursue their own, private objectives only. Given their public responsibility, prudential supervisors have a legal right to know about the banks subject to their supervision. They should consequently have an information advantage compared to banks' counterparties. The upshot is that even if banks' transparency is enhanced through greater public disclosure, there will remain a need for a thorough and comprehensive prudential supervision. This explains the three pillars in the new Capital Accord.

Interestingly, Pillar 2, the supervisory review process, is an essential complement of the Accord. The application of bank specific risk measurement systems, such as IRB, under Pillar 1 will result in bank specific capital requirements. Inevitably, since banks and their risk measurement systems differ, this will reduce the level playing field. This development, however, is counteracted by Pillar 3, which requires that each bank provides specific disclosures about its risk management and capital measurement. Yet, although there will be greater transparency about banks' capital requirements, there is a risk of too much subjectivity. For that reason, there is an additional supervisory review of the matter, which is called Pillar 2, as a necessary complement to Pillars 1 and 3. This, incidentally, raises a more general question for accounting standard setters. In the banking sector, figures based on new measurement techiques (Pillar 1) and disclosures (Pillar 3) will be complemented by a supervisory review (Pillar 2). If the application of new accounting standards in the corporate sector were to result in similar intrusions into the level playing field, this could be counteracted partially by greater disclosures. But who will then be supervisor or overseer?

Against this background, oversight and enforcement with respect to financial reporting and disclosure must be strengthened. The Dutch government has recently announced its intention to do so. Three elements are worth noting. First, application of eminent and internationally harmonised accounting standards, as Europe moves to adopt IAS by 2005. Second, an adequate check of these financial reports by external auditors. Third, an adequate oversight of compliance with the accounting standards and reporting requirements. The government has proposed that the Netherlands Authority for the Financial Markets (Au-FM) be entrusted with the task of executing this type of oversight, which is essential for the confidence in financial reporting by Dutch listed companies, as well as to the well-functioning of financial markets. The Nederlandsche Bank and the Pensions and Insurance Supervisory Authority will co-operate with the Authority for the Financial Markets, and will oversee prudential areas in financial reporting. Apart from this, there is an issue of oversight on the auditing profession. This will be introduced as well.

Also, a brief comment on the US Sarbanes-Oxley Act. Under the Act, the SEC receives new powers, although its role continues to be that of enforcement and oversight. The Act provides for an independent Public Company Accounting Oversight Board, and prescribes audit quality and corporate governance measures. Also, it directs the SEC and other US government agencies to undertake comprehensive reviews of corporate governance, the segregation of audit and non-audit work, and the role and functioning of credit rating agencies. Moreover, the Act strengthens the disclosure requirements for public companies, notably in the areas of off-balance sheet transactions and insider trading. An interesting question, of course, is: how will the Act affect Europe? The debate on the implications of Sarbanes-Oxley for Europe is ongoing. The extent to which the Act will be effective, will also depend on the budget that the Administration intends to provide to the SEC. But what Europeans in any event need to appreciate, is the comprehensiveness of the US approach.

The EU in its turn has launched a major effort to improve its members' corporate governance regimes. Also, the EU adopted the regulations which require the use of IAS by EU listed companies in 2005. This deadline will require EU Member States to step up their transition from national to IAS. In addition, the EU supports global convergence through the IAS process on important accounting issues, such as the treatment of financial instruments, performance reporting, consolidation and share-based payments. Furthermore, expanded rules on auditor independence are being drafted.

Concluding remarks

Let me conclude. The subject of my address, accounting standards, transparency and supervision, is fairly complicated and has many aspects. First, although confidence in financial reporting has waned, this is due to many factors, of which accounting deficiencies are only one, albeit important element. Moreover, these factors are being redressed where possible. Second, accounting standards need to be adapted regularly to new developments in business and finance. This is not easy, given the many innovations being introduced all the time. Not only do accounting standards need adjusting, the broader corporate governance context needs to be addressed as well. Third, greater transparency, through public disclosure and improving market discipline is vital to restoring public confidence. Fourth, although prudential supervisors encourage transparency, this is no panacea. Transparency cannot do without adequate supervision and oversight. Finally, I haven't said much today about auditing. But if ever there was a need for high quality auditors, it is now.

Thank you.