Andreas Ittner: Accounting is all about trust

Speech given by Mr Andreas Ittner, Vice Governor of the Central Bank of the Republic of Austria, at the fifth ECB conference on Accounting, financial reporting and corporate governance for central banks, Frankfurt am Main, 21 June 2016.

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Ladies and gentlemen,

At a dinner party one should eat wisely but not too well, and talk well but not too wisely. Bearing these words of William Somerset Maugham in mind, I will do my best to neither bore you with technical stuff, nor to spoil your appetite with too wise remarks. But if I may just stay with that quote for a moment: Shakespeare lovers among you may have recognized that it is a paraphrase of a speech by Othello, in which he describes himself as "one that lov'd not wisely but too well". His tragedy is that he allows his reading of reality to be coloured by jealousy (and Iago's deceit), which destroys his trust in his wife's love and fidelity.

I hope you won't find it too heroic a leap from here to the observation that the financial markets in which central banks, commercial banks and other players operate are crucially dependent on trust. Trust in the basic integrity of the institutions and corporations that make up the market, in the rules by which they play, and in the information that they disclose to the market.

1. Central banks

So let me start with some thoughts about the evolution of central banking and the importance of financial reporting in this process.

Central banks have always been confronted with changing in economic and legal conditions in their activity. These changes are often the result of crisis and the danger of financial and economic collapse.

Permit me, in its 200th anniversary year, to cite the example of the Austrian central bank, one of the oldest central banks in Europe, which was created in a crisis situation after the long years of the Napoleonic wars to stabilize the troubled economic and financial situation of the Austrian Empire, and in particular to restore trust in the national currency.

Public trust in the national currency was the starting point for the need to publish financial statements of the Austrian central bank. Our bank was founded after the Napoleonic Wars and the Congress of Vienna in June 1816, as a better trusted agent and intermediate with commercial banks after the Austrian-Empire had issued paper money on a grand scale. The first monthly financial statements were published in 1848 (so called Revolution Year in Austria and much of Europe) a year of public riots against the government in the Austrian Empire. The purpose of the publication was to reassure the public that the paper money was covered by adequate silver holdings. After some years of prosperity the first significant financial crisis then also triggered the publication of the central bank's balance sheets from 1863 onwards. The legal necessity to publish weekly balance sheets in order to prove the coverage of the national currency by adequate assets like gold holdings and foreign currency holdings of the Austrian central bank continued until 1999, when we joined the Eurosystem. From that point on the ECB continued with this task for all National central banks of the Eurosystem by its consolidated weekly financial statement until today.

Nowadays, the tasks of a central bank in the framework of the European Economic and Monetary Union are well defined. They include both the general aim of price and financial stability, and the development, the implementation and the monitoring of compliance with, new regulations. To secure the objective of price stability, the independence of the central bank, especially with regard to monetary and macroprudential policy, is a major prerequisite. It has been recognized that the "leaning-against-the-wind" function requires a central bank that is not subject to the pressures of day-to-day politics. For the government and/or parliament to cede this power to the central bank, they need to have the assurance of extensive central bank accountability and transparency; always tempered, of course, by the amount of confidentiality necessary in order to remain effective, and indeed independent, for example with regard to the voting behaviour of individual monetary policy committee members.

A central bank's monetary policy decisions are discussed in the mass media and the general public, and not only the decisions themselves but also their financial results. Financial results have become more important – and more difficult to earn – in a "new normal" environment of ultra low interest rates and rising costs stemming from increasing tasks of central banks, and also in the context of issues like income and loss sharing which are typical for currency systems consisting of many countries, like the Eurosystem.

Central banks' capital adequacy and the definition of financial buffers are usually caught in a tension between, on the one hand, domestic laws, which vary considerably in their definitions of capital and its components, and, on the other hand, systemic balance sheet growth, which is a necessary consequence of central banks' interventions in the financial and economic crisis. As central banks are mostly government institutions or publicly owned companies, their capital is mostly limited by domestic laws. In cases of substantial balance sheet growth, existing rules might not fit anymore. At such times the financial reporting framework might have to provide possibilities for new appropriate solutions.

One such solution might be for recapitalisation by domestic governments after losses, or for potential future losses, to be made mandatory, however such requirements are often difficult to get approved by parliament and by public opinion.

Designing the adequate level and composition of the capital of a central bank is a sensitive challenge. One has, among a number of other internal and external factors, to take account of the central bank's legal environment, the relationship to the government, and its special tasks, like lender-of-last-resort function, or a fiscal agent-function vis-à- vis the state. In any event, a central bank's capital must be sufficient to maintain its independence from the political sphere, and to provide a buffer for the inevitable price volatility resulting from the current investment environment.

The individually adequate balance for each central bank between a suitable accounting framework, profit distribution rules and the ability to hold or reserve adequate amounts for loss coverage is the key for financial independence. When you apply the accounting rules to arrive at the annual financial result, you are then confronted with the question of applying rules for the distribution of profits. These rules can be classified in six general legal profit and loss schemes according to a recent ECB study on profit distribution and loss coverage of central banks (by Werner Studener and his colleagues).

The study, based on the experience of 57 central banks that provided data for the ECB analysis, confirms what the BIS found in 2013, namely that there is no one-size-fits-all solution for central banks, neither for the level of capital and financial buffers nor for profit distribution and loss coverage; nor, indeed, for recapitalisation rules. However, there is evidence that these topics are interconnected and a set of guiding principles have been identified, which help to find an individual balance.

2. Commercial banks and corporates

As I said earlier, financial reporting is a key issue, not only for central banks, but for all kinds of businesses and, of course, commercial banks as well. Modern historians agree that the invention of double entry bookkeeping in the fifteenth century was a major driver for modern economic pursuit and capitalism, as it first introduced the maxim "Increase your equity!" Or, in the words of Charlie Munger (of Berkshire Hathaway): "Double entry bookkeeping was a hell of an invention."

Now even more than it did back then, accounting poses a considerable challenge and uses huge resources. The need to provide a true and fair view of ever more complex and sophisticated transactions, to the satisfaction of an ever wider range of stakeholders, has led to rather complex accounting rules nowadays. As Sir David Tweedie, the former chair of the IASB once said, “anyone who thinks he understands IAS 39, has not read it properly.”

But time will tell if IFRS 9 is capable of doing a better job.

The new impairment model, with its paradigm change from allowances based on incurred losses to risk provisions based on expected losses, will have a huge impact on financial reports of banks and their analysis. It can be expected to lead to considerably increased impairments at initial application, and over time to a higher degree of volatility.

Will IFRS 9 add to the trustworthiness of accounts? The primary aim of IFRS 9 is to establish a significantly improved accounting standard for presenting users of financial statements with information that is relevant, useful, and more comprehensive in assessing the amounts, timing and uncertainty of a firm’s cash flows from financial instruments. Provisions for bad debts will be larger and maybe more volatile, and adopting the new rules will require a lot of time, effort and money. As of today, I understand, it is unclear if the new accounting rules will strengthen the trustworthiness of accounts because of the complexity of the standard.

3. Banking supervision

Another demanding issue, especially in the context of European integration, and of banking supervision in the Banking Union, is the variety of legal bases for accounting rules. On the one hand, certain jurisdictions oblige preparers to base their financial statements entirely on IFRS. On the other hand, several member states still rely on their national GAAPs, at least for financial statements on solo level.

Nowadays we find advocates of both approaches. The ones argue that uniform accounting rules are key in an economic union. The others favor the retention of national GAAPs which, compared to IFRS, in several ways incorporate a greater degree of prudence.

In the context of European supervision, we are currently seeing efforts to overcome this diversity in accounting rules for the purpose of developing a set of key risk indicators for cross-sectoral and cross-country comparisons, by translating national-GAAP numbers of banks to, for the lack of a better word, fictitious IFRS data.

Therefore, as supervisors we are moving in an area of conflict between the goal of achieving a level playing field and of avoiding the use of inaccurate data based on vague translations from nGAAP to IFRS. The trade-off can also be seen as that between the attempt to capture “reality” as faithfully as possible against the need to develop and apply a robust – even if not perfect – signalling tool for European supervisory action. This seems to be rather dangerous. Eventually it can be used to identify trends in the industry but certainly not to trigger supervisory action on a single bank.

4. Accountants and auditors

I cannot conclude these remarks without at least touching on an essential component of a trust-based environment, and that is the accounting profession. The accounting frameworks, as we have seen, attempt to reconcile the information needs of a variety of stakeholders and will change along with those needs and with the economic setting. What remains in all circumstances, though, is the need for accountancy practitioners and audit professionals who have the skills to understand the transactions and relationships underlying the financial reports, and who can manage their conflicts of interest to the highest standard of international practice. (I may add, from my particular vantage point as a prudential supervisor of banks, that we are frequently amazed at the fragility of audited bank accounts under supervisory scrutiny, and at what are often accepted as plausible assumptions.)

In order to support confidence in the statutory audit, it has been necessary to implement different reforms at the European level. These include the mandatory external rotation of auditors to avoid dependencies in companies of public interest and the restriction of non-audit services by the auditor during the audit mandate. Additional measures, which lead to an increase in the quality of audit were also necessary. This applies to the mandatory application of International Standards on Auditing by the auditors and quality assurance checks by national authorities. An increased audit quality will also strengthen the confidence in financial statements and audit reports, that are able to withstand inspection by enforcement bodies.

5. Conclusion

And so we see that for the financial system to have the trust of those inside it and those outside, we need four things to be in place to a significant degree:

- Transparency of methodology and outcomes;
- Well designed tools and rules;
- Well balanced institutional checks and balances, including self-correcting and learning mechanisms.

And finally, personal integrity of practitioners. This is key. In the end, both the auditors and the financial directors who sign off on financial reports, and their supervisors, must be constantly aware of their fiduciary duty to the public and to the continued functioning of the delicately balanced, fragile, trust-based system they operate in.

Thank you for your attention.