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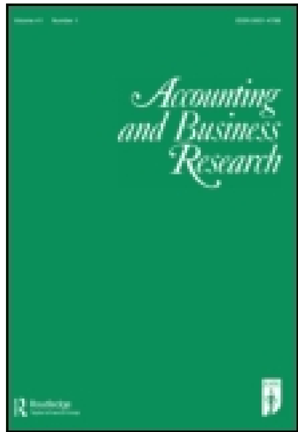

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Discussion of 'The pros and cons of regulating corporate reporting: A critical review of the arguments'

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Discussion of 'The pros and cons of regulating corporate reporting: a critical review of the arguments'

David Lindsell*

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As I listened to the paper, in my capacity as enforcer, which is a form of regulator, I was wondering if I was the living embodiment of the capture theory, on the basis that the Review Panel is composed of chief financial officers, auditors and lawyers, who collectively represent the regulated. However, I have to say that most of the interactions I have had with my customers would not lead me to think that they think we are captive to them.

My comments on this paper take the form largely of questions rather than answers. That, after all, is consistent with my role as an enforcer. I am clearly not an academic; I am a humble bean counter turned enforcer.

The authors gave us a fascinating insight into theories of regulation, summarising a good deal of research relating to corporate reporting disclosure, and then moving on to recent accounting regulatory issues, particularly the fair value debate and the political pressures that have arisen.

Their paper sets out to provide a framework within which you might be able to evaluate some of the pressures arising currently from the financial crisis in terms of the impact on the regulation of financial accounting, and isolating issues for further research. That is an ambitious topic, and I found it a bit difficult to see the connections between the different parts, but I think it is a great enterprise to undertake.

I think it is quite difficult to connect the theories of regulation overall with disclosure regulation. Maybe that is just as well because, after all, if the capture theory – the theory, you may remember, whereby the regulators are captured by the regulated – is correct, then I would have thought the policy implication is that government-backed standard-setting should cease and standard-setting should become a free market process again. However much you might like that idea, it is clearly pie in the sky, and, of course, it would put me out of a job!

The paper discusses, under the heading 'The case for mandatory disclosure', the market incentives to disclose all available information in relation to financial reporting. In that context it notes that there is an inevitable resistance to disclosing proprietary information effectively to competitors. However, in financial reporting it is a much bigger, broader issue than disclosure of proprietary information. It is about balance in financial reporting.

If the incentives to disclose fully all relevant information to the market were strong enough, we in the UK would never have had the Cadbury report in 1992, which said, 'Boards should pay particular attention to their duty to present a balanced and understandable assessment of a company's position. Balance requires that setbacks should be dealt with as well as successes.' It is not just a question of proprietary information, it is a question of a much broader balance in disclosure.

The paper goes on to refer to the analysis by three US academics under the heading 'Regulation of accounting standard-setting' that focuses on the ideology theory of regulation, which is an interesting and attractive theory. This is, of course, where regulators are seen as being endowed with political ideologies and being subject to influence by pressure groups (although seen as a positive influence rather than having negative, bribery-type, connotations).

The real trouble with that theory is that it does not seem to me to get you very far because all it does is acknowledge that the whole regulatory environment in any territory must depend upon the ideologies of a particular regulator and the nature and extent of lobbying activities directed at them. The theory therefore makes no prediction about the optimality of regulation, and so you start to wonder why the theory is of any practical use. The authors of the study do too, in a sense, because they acknowledge

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that it comes down to whether there are mechanisms in the standard-setting process that minimise the effect of idiosyncratic, very odd ideologies and special-interest lobbying. And because an optimal outcome cannot be guaranteed, their solution, as the paper indicates, is to have competition amongst standard-setters. But however nice this is in theory, one cannot see now any realistic prospect of competition between standard-setters.

It has become increasingly clear that the ideology – I would say it is a theology – of fair value is shared, as we have seen, by the international and the US standard-setting priesthood. They are committed to developing a single universal bible of accounting, and the two churches are dead set on uniting. So the only way that you could ever see any competition is through governmental action. Our problem in the UK particularly is that the only way there could realistically be competition now would be if we had European standards. Very, very few people in the UK want that. On the other hand, a lot of people in the UK are very doubtful whether convergence of international and US standards could be achieved without importing the unattractive rules-based mentality and adversarial enforcement approach that characterises US financial reporting. So there is no easy answer to this.

The paper moves on to discuss the increased political involvement in standard-setting in the wake of the financial crisis, and refers to the demands made on the IASB and the FASB to relieve some of the pressure on bank balance sheets that was perceived to derive from fair value accounting. The paper raises the possibility that the increased discretion granted to financial institutions during the crisis may have weakened market disciplinary forces by reducing bank transparency and may have increased the potential for opportunistic behaviour by bank managements and may have allowed essentially insolvent banks to continue operating. It cites research that appears to confirm these possibilities. However, I would say that in view of the very fundamental changes that occurred in the credit markets and their impact on asset valuation methods and assumptions, any claim to be able to produce reliable evidence of these types of outcome at the moment must be regarded with considerable scepticism.

As regards allowing insolvent banks to continue operating, well of course, that is exactly what happened – but we should not be surprised! History tells us that this is typically what happens when a crisis is potentially life-threatening to the system. It happened in the secondary bank crisis at the end of 1973, although it was much smaller, in the sovereign debt crisis in the early 1980s, and of course the collapse of Lloyd's. What has happened in the meantime since all those things happened may not be so much an increase in the interventionism of regulators as an increase in transparency that makes it more difficult for regulators to make informal arrangements to safeguard the system. This brings me towards my one key point that I would make, but let us look at something else in the meantime.

The final part of the paper's analysis discusses the regulatory response in the US to pressure for relaxation of the mark-to-market valuation rules, on the basis that, as was widely argued by banks, valuations were increasingly being depressed by large liquidity risk premiums rather than default risk premiums, and that this was causing what was described as pro-cyclical deterioration in bank asset prices or values.

The paper discusses in very practical terms the benefits and the drawbacks of addressing what was essentially a bank regulatory issue through the accounting standard-setting process. The really fundamental question is how the introduction into accounting standards of recognition and measurement rules that are required for prudential regulation purposes, designed to promote financial stability – how that importation can be reconciled with the objective of preparing financial statements that support the efficient allocation of capital by financial markets. And that is the big, $64,000 question, which is why some of us think there should be a clear separation between prudential regulation and the regulation of publicly-reported financial statements.

The paper rightly points out that in the aftermath of the financial crisis, accounting standard-setting has been subject to greater political pressure than ever before. However, we should not be surprised by this. If you take the UK as an example, history shows that each significant change in the scope of financial reporting and regulation in the UK has been in response to spectacular corporate failures and other financial scandals involving poor financial reporting. It was true of the Dearing Report in 1988, which resulted in the formation of the Financial Reporting Council; the Cadbury report in 1992, which introduced, of course, the first corporate governance code with which companies in the UK were expected to comply; and the post-Enron initiatives such as the Higgs Report and the setting up of the Professional Oversight Board.

It seems to me therefore, getting to my own theme, that applying theories of regulation to discrete episodes or events fails to recognise that events are a product of their history. It seems to me

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necessary to study the history of financial reporting regulation in order to understand the dynamics of the regulatory response to developments and in order to distinguish the main drivers of the system from mere description.

I should like to close my comments with a personal experience that demonstrates the importance of understanding the history of issues when trying to assess their current status. The paper refers to the regulatory debate over fair value accounting and proposals by the Financial Stability Forum as if they were entirely a product of the financial crisis. In fact, the financial crisis has merely enabled the regulators to force the accounting standard-setters to take on board some of the views that they, the regulators, had been expressing, and the standard-setters resisting, for some time.

I was a member of the Standards Advisory Council of the IASB in June 2006, which was well before the onset of the financial crisis – nobody thought of any financial crisis at that stage – when a Council member from the European Central Bank with responsibilities for financial stability raised five issues in relation to accounting standards. He expressed concerns about these issues:

- first, the 'own credit' issue, that is recognising liabilities at fair value;
- second, the conflict between accounting and risk management in relation to bank demand deposits and the inability under IAS 39 to use them for interest rate hedging purposes, which, of course, gave rise to the IAS 39 European carve-out that was supposed to be temporary but has never been resolved;
- third, the limitations of fair-value measurement and its potential, as the ECB representative said, to inject artificial volatility that degrades the information value of prices and induces sub-optimal real decisions;
- fourth, the incurred loss model of loan loss provisioning, arguing as he did that the expected loss model provides a more accurate representation of the fair value of the credit risk that a bank is exposed to;
- and then finally, and least controversially, the inadequacy of single-number reporting of valuations and the need for information in accounts that would more accurately reflect the distribution of values in order to address better the reporting of risk.

Do those issues sound familiar? Of course they do! As I recall, in June 2006, IASB members lined up to oppose all these points other than the last one. However, it looks as though on all these issues the IASB, which was so dismissive of them in 2006, has now taken on board pretty well all the concerns expressed by the central banker.

The point I wish to make is that it is only by placing the present in the context of the past that we are able to foresee the direction that the regulation of corporate reporting might take and to evaluate the implications of possible future directions and to try and stop some of the less desirable trends and influences that might otherwise arise.