Bringing transparency to financial reporting: towards an improved accounting framework in the aftermath of the credit crisis

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The credit crisis, amongst other things, is a crisis of confidence. What was once considered a problem limited to losses on US subprime mortgages has now spread throughout the global financial landscape. A lack of understanding of where these losses have landed has resulted in a significant downturn in financial and economic activity.

Confidence will only return once investors are satisfied that the true extent and location of these losses has been fully disclosed. For this to be achieved –despite siren calls the contrary– the financial system requires greater, not reduced levels of transparency and disclosure. The International Accounting Standards Board (IASB) is mindful of its responsibilities, and its work in conjunction with the Financial Stability Forum (FSF) is aimed at improving financial reporting in a number of key areas.

Today, the world's financial markets are facing what could rightly be called a crisis, and the implications are far-reaching. Lending from financial institutions has dried up as they seek to recapitalise. Investors and managers are still seeking to assess their losses resulting originally from the US subprime lending. As a result of this unprecedented situation, economies throughout the world are slowing. Unemployment is rising in many countries. This is all occurring at a time when the spectre of inflation has returned.

It is therefore understandable that policymakers have made developing an appropriate response to the credit crisis a priority. Because of the global dimensions of the current crisis, the response must be an international one as well, requiring coordinated efforts amongst regulatory authorities.

While this paper does not provide a thorough analysis of causes of the current credit crisis, it is evident that at the heart of the crisis were bad lending practices. Bad lending was then compounded by the absence of prices in the secondary markets for some structured credit products and uncertainty about the location and size of potential losses. This in turn led to funding difficulties caused by the reluctance to extend credit to a number of financial institutions thought to hold low-quality liquid assets. Financial reporting enters the scene by way of its requirements to value these assets and to alert the markets to risks associated with their existence.

My personal view is that showing the changes in values of these securities, even if imperfect, provides much needed transparency and enables markets to adjust in a necessary, even if painful manner. I am not alone in this assessment. The Chartered Financial Analyst (CFA) Institute, representing financial analysts throughout the world, asked its members whether fair value requirements for financial institutions improve transparency and contribute to investor understanding of the risk profiles of these institutions. 79 percent said yes. While a slight majority believed that fair value had a role in prolonging the credit crisis, 74 percent surveyed believed that fair value accounting improved market integrity.[1]

None of this is to say that International Financial Reporting Standards (IFRS) are perfect, and IASB is now considering improvement to its standards in the light of developments. The IASB is conscious that improving existing accounting practices has proved valuable in addressing crises in the past, as was seen with the Asian financial crisis (in part, a catalyst for international accounting standards and the formation of the IASB) and the failure of Japanese banks and the US Savings and Loan crisis in the 1990s (which prompted new accounting standards for derivatives and other financial instruments). These are valuable lessons and their remedies should not be discarded lightly.

While the current crisis plays out, it is important that all those who have a stake in the efficient functioning of capital markets consider what improvements can be made, and the IASB is no exception. However, it is equally important that any response should be measured and appropriate.

1| Responding to the crisis at hand

In the area of financial reporting, the credit crisis raises questions both regarding the appropriate immediate response by the IASB and the longer-term issues about the accounting of financial instruments. The IASB is responding to both questions.

The IASB continues to work closely with the FSF, which has been designated by public authorities to manage the regulatory response to the crisis. The Financial Stability Forum report, adopted by the Group of Seven (G7) Finance Ministers and Central Bank Governors made recommendations for enhancing the resilience of markets and financial institutions.[2] The report was the result of collaboration by the main international bodies and national authorities in key financial centres. It set out 67 recommendations, which were endorsed by the G7 on 11 April.

1 *See* http://www.cfainstitute.org/memresources/monthlyquestion/2008/march.html.
2 *See Report of the Financial Stability Forum on "Enhancing market and institutional resilience", April 2008, available from* www.fsforum.org.

Of these recommendations, three relate to enhancements to financial reporting and form the core of the IASB's response to the credit crisis. They relate to three topics: fair value measurement and its disclosure, consolidation, and derecognition. The IASB had a role in developing those recommendations and strongly supports the approach outlined. The recommendations were as follows:

1|1 The IASB should improve the accounting and disclosure standards for off balance sheet vehicles on an accelerated basis and work with other standard-setters towards international convergence.

IASB response: the IASB already had two projects under way directly related to off balance sheet vehicles. The consolidation project identifies when an entity should be brought on to another entity's balance sheet, whilst the derecognition project examines when assets or liabilities can be removed from a balance sheet. Both of these projects are described by the Memorandum of Understanding which sets out a roadmap for convergence between IFRSs and US General Accepted Accountings Principles (GAAP). The inclusion of both these projects in the convergence programme with the Financial Accounting Standards Board (FASB) should ensure consistency of accounting in these areas in the world's major markets.

The IASB has prioritised both projects in order to accelerate their completion. Public discussions about the proposed new consolidation standard are about to begin with an exposure draft of the consolidation standard expected to be published during the second half of 2008. IASB staff have also been developing proposals to improve derecognition requirements, which they expect to present an update to the IASB during the IASB's meeting in October.

1|2 Fair value in illiquid markets: the IASB should enhance its guidance on valuing financial instruments when markets are no longer active. To this end, it will set up an expert advisory panel in 2008.

IASB response: it is undoubtedly difficult to value complex, illiquid, structured credit securities. However, it is important to understand the current requirements in IFRSs (and US GAAP). Many of the loans that triggered the crisis were in fact shown at amortised cost in the books of financial institutions. When recoverability of a loan is doubtful the loan has to be marked down, even under historic cost accounting, to the present value of the cash flows expected from the loan –that value would be similar in many ways to fair value. No entity is ever allowed to disclose assets valued at more than their recoverable amount in its financial statements.

That being said, the IASB is committed to determining whether additional guidance is needed to address the question of fair value measurement of financial instruments when markets are no longer active. During its meeting in May 2008, as part of its fair value measurement project, the IASB announced the creation of an expert advisory panel to identify valuation and disclosure issues encountered in practice in the current market environment. The panel met for the first time on 13 June and will meet as a whole or as a subgroup several times throughout July and August of this year. The discussions of the panel members over the coming weeks will give the Board insight into the type and extent of additional guidance that might be necessary in this area and the form of any such guidance. We have ensured that the panel is made up of experts from over twenty organisations such as the Basel Committee on Banking Supervision, the Financial Stability Forum, central banks, financial institutions, and accounting firms. Our aim was to select participants based on their practical experience with the valuation of financial instruments in the current market environment.

The panel started its work by creating a description of practical issues experienced with the valuation and disclosure of financial instruments in the current market environment. The insights from this and their experiences will go towards the creation of additional guidance.

This is an important initiative. The principles-based approach to IFRSs has been widely supported; however, the application of broad principles also requires good judgement based on practical experience and sound training. The panel will seek to identify the practical challenges of consistent application of fair value when markets become inactive and will help the IASB and the FSF to decide how best to get any guidance into the marketplace as quickly as possible.

1|3 Disclosure: the IASB will strengthen its standards to achieve better disclosures about valuations, methodologies and the uncertainty associated with valuations.

IASB response: in 2007, new disclosure rules related to financial instruments and associated risks came into place. These new disclosure rules, partly developed with the assistance of bank supervisors and the private sector, enhanced the quality of disclosures significantly. Indeed, it is interesting to note that the short-term funding risks associated with Northern Rock bank in the United Kingdom were set out in their annual accounts after they adopted IFRS 7 *Financial instruments: disclosures*.

We can always improve and learn from experience. The IASB has now begun reviewing IFRS 7, to assess its effectiveness in ensuring that entities disclose information that reflects their exposure to risk and any potential losses arising from financial instruments with the off-balance sheet entities with which they are involved. IFRS 7 also includes disclosure requirements in relation to fair value measurement and these requirements are included in the review.

The steps taken to date include consultations with preparers, auditors, users and regulators of IFRS compliant financial statements, an analysis of good disclosure practice observed in financial reports and a review of good practice suggestions made by regulatory bodies. The staff expects to be able to present proposals to the IASB in September.

The IASB is also working expeditiously on its general proposals on fair value measurement. That project is aimed at providing consistent guidance on the measurement of fair value and related disclosures, when IFRSs already require the use of fair value. As noted previously, we have established an advisory group of experts to assist in that project and believe that its conclusions will provide greater clarity to users of financial statements and others in the application of fair value by an entity. We will also draw upon the experience of the US GAAP from FAS 157 *Fair value measurement*.

2| Addressing the question of fair value in the long-term

The question of the appropriateness and extent of fair value accounting, particularly for financial institutions, will not go away when the credit crisis subsides. We know that even when the IASB has addressed the three areas above, many will still argue that the IASB must deal with more fundamental issues of fair value accounting. Indeed, a number of commentators have argued that, apart from the three areas above, the use of fair value accounting was at the heart of the current crisis, or at the very least exacerbated the crisis.

To some extent, the broader questions of fair value accounting, inevitably raised in regard to the current crisis, address issues that are fundamental to the future of accounting. How much transparency is a good thing? We at the IASB start from the premises that financial reporting that is derived from our standards is targeted primarily at investors and providers of capital. Our conceptual framework enshrines that principle. Investors generally argue that it is the job of financial reports to reflect the economic situation of an entity at a particular time. Others argue that this introduces unnecessary volatility into financial reports that leads to suboptimal decision-making.

It is in the area of financial instruments, embodied by IAS 39 *Financial instruments: recognition and measurement*, that the use of fair value is most germane to the current crisis and has come under the most scrutiny. IAS 39 existed before the IASB was constituted, but the IASB has reaffirmed that there appears to be no alternative to fair value accounting for derivatives and similar financial instruments. For example, two parties may enter into an agreement based on exchange rate movements between two currencies. There is no cost price for this type of derivative (outside minor transactional costs). However, shifts between the two currencies could trigger significant gains or losses –which are real. Traditional cost accounting is meaningless in this situation. On the other hand, fair value accounting gives a better description of the financial position.

It is true that elements of the standard are complex, some needlessly so in my mind to accommodate exceptions to principles. IAS 39 employs a multitude of different measurement methods depending on the stated intention of the holder or issuer of the instrument. Therefore, the IASB believes that even though IAS 39 brings about significant discipline and transparency, IAS 39 is not a long-term solution for accounting for financial instruments. The IASB has recently published a discussion paper[3] setting out the challenges and considering potential solutions. The fundamental question being asked is how far should we go towards improving and simplifying the reporting of financial instruments? For example, should we go as far as applying a single measurement method for all types of financial instruments (with appropriate presentation and disclosures)? If so, the only measurement method that seems appropriate for all types of financial instruments seems to be fair value (or some similar current value measurement method).

As with many areas of valuation and measurement, there are difficult questions to consider with no simple answers. It is therefore important that all those who have an interest in the reporting of financial instruments use this as an opportunity to express their views on this important issue.

3| Drawing on the lessons of the current crisis (and others)

Obviously our review of IAS 39 and accounting for financial instruments should take into account any lessons learned from this current crisis. A key question that many banking supervisors and financial institutions will demand that the IASB addresses is whether accounting standards should take questions of financial stability and the potential pro-cyclicality into account.

This issue goes to the heart of the IASB's mission and the purpose of financial statements in the view of the IASB and our *Framework*. IFRSs are designed to provide an economic assessment of an entity at a particular date –to record the value of an entity today, not what it was worth yesterday or to predict the value of it tomorrow. It is for others to use information provided by financial statements as a basis to make assessments of an entity's future performance based on reliable, comparable information provided by IFRSs.

The debate surrounding the use and appropriateness of fair value for financial instruments is often portrayed as a technical accounting matter, but it is both broader and of relevance to more than just accountants. The fundamental question is should an accurate assessment of an entity's economic position at the balance sheet date be reported, or should a degree of opaqueness be introduced into financial reporting?

We often hear that our approach encourages volatility in financial statements. Volatility is not invented and when companies report volatility that volatility is real. The change in the value of assets and liabilities is an economic event and all businesses are exposed to economic volatility. It results when changing events occur in the economic environment in which an entity operates. And all the accounting does is to attempt to describe the situation as best as it can be measured.

Another argument often used against fair value is that its application has caused a downward spiral

3 *Reducing complexity in reporting financial instruments, available from* www.iasb.org.

in prices –so-called pro-cyclicality– that artificially depresses market values and ultimately forces these institutions to seek additional funding in order to meet their regulatory capital requirements. Some have argued that during times of extreme stress in the markets a form of circuit breaker in the financial statements is required to prevent such a downward spiral occurring.

While accounting standards *may* result in some element of pro-cyclicality, we remain cautious of any attempt to address this issue through the standard-setting process. Financial statements contain information that should enhance transparency for investors and hence improve the ability and willingness of an investor to take an investment decision. Attempts to suppress such information will simply erode market confidence with investors applying a healthy risk premium or seeking investment opportunities elsewhere.

It is for this reason that I believe any attempts to place so-called circuit breakers into the system should be applied to prudential regulation requirements rather than in the published financial information –a view which I believe is gaining increased traction. We recognise that supervisory authorities have the ability to adjust numbers and capital requirements if appropriate, and, of course, continue to work with supervisors to reach a consensus on the accounting requirements, but our different perspectives and objectives often lead to slightly different approaches.

The crisis in credit markets, amongst other things, is a crisis of confidence. Confidence that counterparties will be unable to honour transactions has already claimed one large US financial institution with a history dating back over 80 years and frozen interbank lending across the world. It is only when confidence begins to return that credit markets will return to some sense of normality.

It is for this reason that transparency and disclosure must be enhanced, not reduced. Where there is doubt and uncertainty, there will remain a dearth of confidence. Markets and sophisticated investors will not be fooled by simply withholding information vital to making appropriate investment decisions. I believe that the broader debate regarding transparency and disclosure has already been decided by the markets. Investors continue to punish companies who are believed to be failing to disclose their true economic position and reward those are believed to have all of the bad news out on the table.

The IASB is an active participant of the FSF and will continue to respond expeditiously to issues raised by the credit crisis. There is much for all to do, and I am encouraged to see international organisations and central banks working in unison under the auspices of the FSF. Whilst this is not a crisis caused by accounting, the IASB is mindful of its role in identifying solutions to the unprecedented challenges being experienced by markets.

The theme of this report is valuation and its publication is timely. Coupled with planned enhancements to disclosures and guidance, transparency offered by improved accounting guidance is part of the cure, not the disease.