"Accounting: Convergence, Governance and Regulation". IASC Foundation IFRS Conference

FERNANDO RESTOY, VICE-CHAIRMAN OF CNMV (SPAIN) AND CHAIRMAN OF CESR-FIN

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Let me first thank Sir David and the rest of the organisers for their kind invitation to participate in this conference. As chairman of the corporate reporting standing committee of CESR (better known by the acronym CESR-FIN), I also take this invitation as a recognition of the tight links between the roles of standard setters and enforcers of accounting principles, and also of the good cooperation that the IASB and CESR have been able to establish.

Yet, the usual disclaimer applies, I will speak under my own personal responsibility.

Introduction

These are not easy times for the accounting profession. The crisis has made life difficult for standard setters, preparers, auditors and enforcers, who face the complex job of contributing to an appropriate representation in financial statements of the implications of the turbulent economic environment for reporting companies.

Standard setters, in particular, have also been subject to enormous pressure—often unduly. They have been repeatedly asked by different stakeholders to modify the standards in different and often contradictory directions, and much attention has been devoted to the way in which standard setters actually followed the different indications.

Not surprisingly, that hot debate on specific accounting issues—mostly related to the treatment of devalued financial instruments—has led to a more structural discussion on issues such as the objectives, accountability and procedures of accounting standard setters. In that regard, attention has focused particularly on three issues: the case for world-wide convergence of accounting standards, the governance structure of the IASB, and the link between the objectives of accounting and those of other regulations, notably prudential regulation. I will try to cover these three matters in the rest of my presentation.

On convergence

Regarding convergence, it is difficult to overstate the importance of achieving a single set of high quality accounting standards. It is clear, however, that an environment in which standard setters face pressure from stakeholders in their jurisdictions to tackle specific issues of purely sectoral or domestic relevance is not the most appropriate one for substantive progress in this field.

Still, I consider that remarkable progress has been made so far. More than 100 countries have already adopted IFRS, and countries such as Japan, India, Canada, Argentina and South Korea have clear plans to adopt IFRS in the near future. As a result, of all the areas related to capital markets, accounting is the one that is closest to achieving unified global regulation.

It is a fact that the US is not yet there. The US authorities are undeniably committed to achieve a single set of high quality accounting standards. However, recent developments in

Congress, the SEC and the FASB do little to reduce the uncertainty surrounding forthcoming adoption of IFRS for domestic issuers in the US. Of course we are fully respectful of the ongoing reflections in the US on the implications of IFRS adoption and we appreciate the complex combination of political and economic interests that has to be taken into account.

Moreover, we can only welcome the ongoing joint projects by the IASB and the FASB—such as those on consolidation, financial instruments, derecognition, fair value measurement, financial statement presentation, leases, post-employment benefits and revenue recognition—and ask the Boards to substantiate them by the recently revised deadlines without further delays. At the same time, it is important to maintain the spirit that convergence work is only a joint reflection on possible ways to improve standards. It would be a big mistake—one which I am sure the IASB will avoid—to consider convergence work as a sort of bargaining game leading to political compromises. We all agree that convergence cannot come at the expense of lower quality.

When we talk about convergence, it is also important to be fully aware that, by itself, a single set of standards does not necessarily imply fully comparable financial statements. Between standard setting and the application of those standards by preparers, there are two important steps that are equally relevant for comparability, namely, interpretation and enforcement.

In the latest revision to the IASCF Constitution, the declared objectives of the Foundation include the commitment to develop a single set of high quality financial reporting standards "based upon clearly articulated principles". For the first time, the principle-based approach is explicitly recognised in an official document. That approach is the only sensible strategy to enable IFRS to accommodate a vast range of different specific economic realities that are relevant for reporting companies around the globe.

However, such a strategy should be accompanied by extensive guidance and a sufficient onumber of examples. Contrary to a common misunderstanding, more examples and guidance do not necessarily clash with a principle-based orientation. This would only happen if the rules and guidance were inconsistent with, or contrary to, the overarching principles.

Having said that, it is clear that action by standard setters to develop guidance and examples cannot (and should not try to) eliminate all potential sources of inconsistent application or all possible uncertainties regarding implementation of the standards.

This is where enforcers come in. Their role is primarily to supervise sound application by reporting companies. But, of course, in doing so they generate a complementary reference for preparers and auditors to understand how accounting principles can be best implemented. That makes convergence of enforcement criteria and practices an essential complement of the convergence of accounting standards in order to achieve fully comparable financial information.

As you know, in Europe we have an effective mechanism for coordinating enforcement activities which may serve as inspiration for what could one day be achieved at the global level. Through the European Enforcement Coordination Sessions, in the framework of CESR-Fin, we believe we are making a helpful contribution to achieving consistent application of IFRS in all the European Economic Area countries.

A database of enforcement decisions was set up in 2004 and 325 decisions have been entered since then. CESR has also published 7 batches, with 94 decisions in total. These decisions are regularly discussed in EECS meetings, which take place 6 to 8 times a year.

Since the beginning of the crisis, we have felt that we could also help preparers and auditors to do their jobs properly in the prevailing difficult conditions by identifying areas of more complex implementation and listing good practices in each area. Examples of CESR work in this regard are:

a) CESR Statement on Fair value measurement and related disclosures of financial instruments in illiquid markets (October 2008).

b) CESR Statement on the Reclassification of financial instruments (January 2009)

c) CESR Statement on the application of and disclosures related to the reclassification of financial instruments (July 2009)

d) CESR statement on application of disclosure requirements related to financial instruments (November 2009)

Needless to say we also have regular written correspondence and meetings with the IAS Board and Staff and with IFRIC. We take that opportunity to convey our opinion on relevant standard-setting issues stemming from our enforcement experience.

As you can easily see by browsing through our statements, much of the work conducted by CESR is related to the quality of disclosures accompanying figures in financial statements. Although we fully understand the attention paid to measurement criteria in financial statements, our impression is that the importance of good disclosure practices—such as those relating to recognition or valuation criteria—has sometimes been overlooked by preparers and auditors. The recent Repo 105 affair constitutes a good example of what I mean, although I do not have the time to expand on it here.

On governance

Regarding the governance of accounting standard setters and of the IASCF Foundation, I have only good things to say about the progress made to date, and that is not only because of the identity of our host. It is clear that the creation of a Monitoring Board—composed mainly of financial regulators—is a wise initiative that is already enhancing the required accountability of the IASB as well as being a useful device to protect its technical independence and due process.

Yet, it is clear to me that the composition of the Monitoring Board is not yet optimal. It makes sense to consider expanding the group to include representatives from a larger number of jurisdictions so as to better reflect the views of stakeholders around the globe.

Moreover you should not be surprised if I am somewhat critical of the absence of European securities regulators on the Monitoring Board. Of course, I am happy to see that the European Commission has finally decided to become a full member of the MB, alongside IOSCO, the US SEC and Japan's FSA. At the same time, it makes sense to consider also the participation of CESR (shortly, ESMA) in the near future. As I have stressed before, CESR groups the market regulatory authorities with the greatest experience in enforcing IFRS. To be sure, if one finds it logical that US and Japan's securities regulators are represented even if IFRS have yet to be adopted for domestic issuers in their countries, the case for participation by CESR is almost overwhelming.

In any event, much work must be done in the future to further strengthen the institutional architecture of the IASB. It is important to find ways to enhance its institutional legitimacy, to ensure stable financing and, why not?, one day (via some sort of International Treaty) achieve full direct application of the standards in all jurisdictions. Of course, I am aware of how far we currently are from even envisaging that goal but, as we say in Spain, dreaming is free!

On the link between accounting and other regulation

Let me now turn to the last part of my talk: the links between accounting principles and regulation.

Since the beginning of the crisis, the case has been repeatedly made that one of the goals of financial reporting standards should be to promote financial stability. Of course it is hard to argue with that position from a general standpoint; that would be tantamount to accepting that accounting standards could run counter to the non-controversial objective of preserving the soundness of the financial system. It is important however to clarify what this objective might mean in practice.

In fact, I believe that good accounting standards do contribute to financial stability by favouring transparency, transparency being a key ingredient of good market functioning and good market functioning being an essential component of financial stability.

It is considerably more controversial to interpret the inclusion of a financial stability objective in the accounting standards constitution as suggesting the need for a sort of conservative or countercyclical bias in financial statements. That would entail modifying the measurement principles for assets and liabilities or the income recognition criteria for reasons unrelated to the objective of promoting a fair and comprehensive description of the reporting company's economic reality.

Although IFRS still maintain the principle of prudence, by no means can it be invoked to justify systematic biases or misrepresentations of the economic reality of the reporting companies. Moreover, it is not obvious that financial stability would be enhanced by adopting measurement criteria that unduly delay the recognition of losses. Indeed the successful experience of the stress tests in the US last year—which is now going to be emulated in the EU—showed that confidence only returned when the actual and potential losses of the banking sector were released transparently.

In other words, it seems wise to let accounting standard setters make the final decision on the best way to reflect reporting companies' financial position and income. They are best positioned to establish the measurement and income recognition criteria that investors and other users of financial information need in order to make informed decisions.

A different angle of the debate—which I find relevant at the current juncture—is whether financial statements generate excessive behavioural consequences. In other words whether accounting conventions—which are supposed to be just an information code—sometimes have an excessive influence on corporate actions that actually affect companies' market value.

A good example of that is the power, whether *de jure* or *de facto*, that accounting standards have to determine not only firms' total income but also the part of income that can be distributed as dividends or bonuses.

As you all know, according to IFRS, Total Comprehensive Income has two components: Profit and Losses (P&L) and Other Comprehensive Income (OCI).

The situation at present is that, under many commercial law regimes, the basis for determining dividends is not the total comprehensive income account but only the profit and loss (or net income) account. Moreover, in countries where this is not the case, such as the UK, firms rarely distribute income which is not reported in the profit and loss account (P&L). In fact, the reported earnings per share under IFRS must be based on the figures reported under profit and losses. The amounts in the Other Comprehensive Income (OCI) account are simply disregarded. That of course favours the interpretation by users that only income reported under the heading of "profits" constitutes current or future remuneration to shareholders. As a result, the profit and loss account is the single piece of information in financial statements which attracts most attention by users.

Indeed, much of the recent accounting debate has focused less on the choice of the measurement criteria—whether amortised cost or fair value—than on how changes in value should be reported in the income statements. In that regard, we should not forget that the IFRS approach (to which there have been no objections to date) is that preparers need to report fair values in the notes when the measurement criteria in the statements is amortised cost. The debate is therefore not about whether or not to report fair values but about the extent to which changes in fair values affect profits.

The terms of this discussion became crystal clear in the fall of 2008 when the IASB decided, under severe pressure, to allow -in rare circumstances- reclassifications of assets between categories. The unambiguous objective was clearly to shield the profit and loss account of financial institutions from the deterioration of a number of assets whose fair value suffered significant losses following the subprime crisis.

Indeed, in a study we conducted in CESR-Fin, we found that, as expected, the majority of the reclassifications made in 2008 were from fair value to amortised cost categories. That helped companies to skip losses arising from the reduction of fair values that would have been reported in the P&L account either directly (if the assets were originally in the trading portfolio) or through impairment tests (if originally in the Avaibale For Sale category).

However, we also discovered that more than 20% of the companies reclassified assets from fair value with changes in P&L to fair value with changes in Other Comprehensive Income. It is clear that, for those companies, the primary target was not necessarily to get rid of fair value but to make profits less dependent on fair value changes in the turbulent market conditions that were prevailing at that time.

The most helpful example is probably that of Deutsche Bank. As soon as reclassifications were allowed in October 2008, Deutsche Bank quickly reclassified 29 billion euro out of its fair value portfolio. This enabled the company to avoid recording 845 million euro in losses that it would have had to report if reclassifications had been forbidden.

Interestingly, or perhaps surprisingly, the trick worked, at least temporarily. On the day it published its Q3 interim reports, on 30 October, Deutsche Bank's stock rose by 17.8%. Therefore, although arguably nothing substantive had changed in the company's reported financial position and the impact of the reclassifications was disclosed transparently, a simple change in an accounting convention provided a large increase in the firm's market value.

Prudential supervisors obviously also pay close attention to the reported profits of regulated companies. Much of what they have requested of accounting standard setters is to make the P&L account less sensitive to the economic cycle. In other words, they would like companies not to recognise too much money in the P&L account in good times or too little in bad times. In contrast, they seem much more relaxed about what appears in the OCI account.

Therefore, the real pressure faced by accounting standard setters from relevant parties is mainly related to the criteria used to determine distributable income.

Indeed, the greater importance given to income recognition over pure measurement in the accounting debate has helped accounting standard setters to achieve pragmatic compromises between the need to ensure accurate measurement and the desire by relevant stakeholders to reduce volatility in reported profits. The preferred approach for that purpose is to use the OCI account to accommodate income which those stakeholders do not want to be recognised as distributable income, i.e. profits.

For instance, in the recent FASB exposure draft on financial instruments, the predominant measurement criterion for most instruments is fair value, even for instruments in which there is no market and which the company plans to manage on the basis of cash flows until maturity. At the same time, the FASB is sensitive to arguments in favour of preventing excessive volatility of the P&L account. How does it do this? By simply sending fair value changes—other than impairment due to credit losses—to the OCI account. Namely, by making those gains and losses seemingly irrelevant for determining distributable income.

The same approach has been adopted by the IASB. In the new IFRS 9, changes in fair values of strategic equity investments are reported as OCI. In order to prevent earnings management—in other words, to avoid spurious transfers from non-distributable to distributable income—recycling of accumulated gains in OCI is forbidden. Moreover, the IASB decided to address the extremely contentious issue of how to deal with fair value changes in liabilities linked to changes in own credit risk by making use of the income dichotomy. Gains or losses associated with variations in own credit risk are not reported as P&L but as OCI and, therefore, become less relevant in financial statements.

Therefore, the distinction between P&L and OCI has so far proven very convenient for accounting standard setters.

However, it is unclear whether this provides a sound and stable solution.

Indeed, it is by no means obvious what type of accounting criteria are used by accounting standard setters to determine what part of income goes to profits or to OCI. Accounting theory gives a very good indication of how income should be determined. Indeed, the Hicksian paradigm permits IFRS to define total comprehensive income as "the total change in equity of an entity that results from transactions and other economic events of the period other than transaction with owners in their capacity as owners". But there is a lack of such deep accounting theory to decide what type of income could be distributed or not…that is, what goes to P&L and to OCI.

In fact, though IFRS contain a definition of total comprehensive income, they fail to provide formal definitions of Profit and Losses and of Other Comprehensive Income. And this is so simply because there is no sensible way to do this. In particular, OCI currently incorporates a substantially heterogeneous list of income sources such as: unrealised or realised capital gains linked to strategic investments, fair value changes of liabilities due to own credit risk, actuarial gains or losses related to post-employment benefits, revaluations of property, plant and equipment or of intangible assets, unrealised exchange differences relating to a foreign operation, effective portion of cash flow hedges, etc. By and large, the split of total comprehensive income between P&L and OCI is arbitrary, in the sense that is not covered by any coherent, conceptually sound accounting framework. This has been recognised by the IASB itself in a recent ED.

Interestingly, the task of deciding what part of income can be distributed or should remain within the firm as reserves seems conceptually closer to the remit of other parties, such as commercial legislators and prudential regulators. In particular, it seems natural to ask corporate law to establish more clearly the conditions under which some of the income generated by a company can or should be made inaccessible to shareholders in regular times.

Similarly, regulated companies might conceivably be subject to prudential rules limiting the maximum amount of dividends or bonuses that could be distributed. For instance prudential regulators should have the faculty to limit the distribution of unrealised capital gains for illiquid – level 3 type – financial instruments. That faculty should be independent of the way those instruments are classified by accounting standard setters.

Nonetheless, in most jurisdictions neither commercial nor prudential regulators provide sufficiently explicit and detailed distribution rules for firms' income. Therefore, at present, the responsibility to determine not only income but also the split between distributable and non-distributable income lies largely with accounting standard setters (in practice, at least, when not *de iure*), even if the issue is of greater relevance to other regulators. A logical consequence is that, from time to time, accounting standard setters experience enormous pressure from regulators to change standards determining P&L in order to accommodate specific considerations which have little to do with the objectives of accounting. I find this an inefficient allocation of responsibilities and also a structural source of risks for the independence and due process of standard setters.

Of course, it would be hard and possibly unwise to perform radical changes in the short term. However an idea that should be explored is to gradually move in the direction of eliminating the current sharp dichotomy within total comprehensive income between P&L and OCI. The standards should rather establish a complete breakdown of income sources including realised or unrealised capital gains of financial or non-financial assets sorted by the valuation hierarchy, but without grouping them, as at present, in two arbitrary categories. Consistent with that approach, the responsibility to define the concept of *earnings per share* should not lie with accounting standard setters.

That would make it more clear that the decision regarding income distribution should be under the remit of other regulators. Moreover, it would clarify that the responsibility to decide on user-specific performance indicators should lie with the users themselves.

Naturally, it is important that financial statements provide sufficient disclosures for those indicators to be calculated directly from the accounts. Moreover, financial statements could report measures of distributable income and regulatory reserves that regulators themselves decide in notes or in the statements themselves. Similarly, nothing prevents the inclusion of performance indicators that become sufficiently standardised. But it should be clear that those are not IFRS concepts.

That strategy would permit accounting standard setters to concentrate in the medium term on what they are supposed to do well: establish sound measurement and recognition criteria for assets and liabilities and rigorously determine companies' total income.

Meanwhile, the recent decision by the IASB to establish a single comprehensive income statement with two sub-items is a move in the right direction. Indeed, it should contribute to a more complete picture of what the firm has actually achieved in the reporting period and dilute the somewhat excessive focus of many users of financial statements on the Profit and Loss Account.

Moreover the idea of a creating a regulatory income account would be a useful additional step in the direction that I am proposing. This idea, recently proposed by David Tweedie, shows clearly that accounting standards can be adapted to reflect that, at least for regulated companies, there could be prudential considerations that filter out the profit and loss account before the decision on dividends is taken. However, it is somewhat surprising that not all prudential supervisors support the application of this apparently powerful prudential policy tool as they seem to prefer that accountants do the job for them by redefining the regular profit and loss account.

Yet, in the medium term, we should try to go beyond the introduction of prudential filters in the P&L account. I think that accounting standard setters—and the rest of the regulatory community—should reflect further on whether much of the pressure that accounting boards are facing now may be due to a somewhat excessive scope of the standards. In particular, as I have argued in the last few minutes, they should consider whether it would make sense at some point to discontinue the current split of reported income into policy-relevant categories for which well-established accounting concepts provide little or no guidance at all.

We should all be aware that the more focused the job of accounting standard setters becomes, the easier it will be to protect their independence and due process.

Thank you very much.