Ken Spencer Memorial Lecture 2010
KPMG Lecture Hall
Melbourne Australia
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Tim Flynn Remarks:

Restoring Trust and Building Confidence

Thank you, Jeff[1]. It is an honor to be here and have the chance to speak with you.

I have a great fondness for Australia. In fact, one of my very first global trips was in 1988, when I spoke at an entrepreneurial conference in Brisbane. My wife Susan joined me. We were pretty young and it was an expensive trip for us, but I found a great deal on a flight! Our journey in 1988 included five stops and three plane changes. We were in coach and, might I add, in the row right in front of smoking, for the majority of the trip. Total time for the journey was 32 hours. I must confess, my journey this time was a little more comfortable.

I am particularly honored to be here today given the distinguished guest speakers the Ken Spencer Lecture Series has hosted. People like Mark Olsen, Chair of the PCAOB, and Sir David Tweedie, Chairman of the International Accounting Standards Board. I want to thank Michael Andrew, Chairman, KPMG Australia, and Michael Coleman, National Managing Partner - Risk & Regulation, KPMG Australia and Deputy Chair of the Australian Financial Reporting Council, for their roles in helping to make this possible today.

Before I get started, let me acknowledge Ken Spencer, whom this series honors, and who I'm proud to say was a KPMG partner. Ken helped to shape many of the financial reporting standards that we use today, and made great strides in advancing IFRS as the global standard. He was a founding Trustee of the IASB and a great ambassador for accountants, for KPMG, and for Australia. And his work is still very relevant today, particularly given many of the conversations going on around the world. I am pleased that Carolyn Spencer has joined us today as well.

There are many topics we could cover today: the state of the global economy; the lessons learned from the financial crisis which emanated from the U.S. and spread rapidly around the world; the proposed regulatory reforms; the current state of the banking system; the continued move towards global accounting standards; the importance of protecting the independence of the accounting standards setting process; the evolving regulation of the accounting profession.

I am sure you can all add a few more. One thing is clear, in challenging times like these, we are not short on topics to discuss! In the time we have today, I want to ensure we touch on the issues of most importance and most interest to all of you. Thus, I thought I would spend about 25 minutes to cover a few of the items I mentioned, and then leave plenty of time for what I hope will be a robust exchange of questions and answers.

I'll start with a few thoughts and impressions gained from my experience in Davos this year about the challenges ahead, then cover some thoughts on regulatory reform and move on to the importance of developing a set of high quality global accounting standards. I will close with some thoughts about what I think is a critical element for a sustainable recovery of the world's capital markets.

Just over a month ago, I attended the World Economic Forum annual meeting in Davos. The typical conversation among participants started with the recognition that we are in the midst of a recovery; that the recovery is fragile; that there are signs of optimism, but

[1] Jeffrey Lucy, Chairman of the Financial Reporting Council

also feelings of caution; that there is a strong recognition that the recovery to date has benefited to a large extent from government stimulus measures; that there are concerns in the short-term as to what might happen when the stimulus runs its course, and an even greater concern as to how governments around the world will recover the US$5 trillion of stimulus.

I think we would all agree that we have had similar conversations. But, as the conversations continued, I was struck by how quickly they moved from short-term concerns to longer-term concerns. These were different conversations than last year.

They were grounded in the recognition that we are not moving through another “recession” or another “financial crisis” where things will simply “get back to normal.” The conversations moved to the powerful structural forces and shifts in economic power that are changing the global economy, shaping the global landscape far beyond business. They moved from talking about the next year, to talking about the next decade. They moved from talking about business issues to talking about the much broader societal issues we are facing. They moved beyond a focus on shareholder value to the focus on the importance of all stakeholders. Consider for a moment some of the trends we are facing around the world.

The impact of the recession on the global economy, particularly in the developed countries, has been severe.

The U.N.’s ILO, International Labour Organization, estimates that 34 million jobs have been lost globally since 2007.[2] In the U.S., unemployment is 10% and expected to remain very high for a very long time. Many countries in Europe are facing the same issue. The situation is better in Australia – with about 5% unemployment. But the view from most of the world is very different.

The younger generation is looking at very high unemployment – more than 20% in many developed countries, around 45 % in Spain. There is the talk of a jobless recovery in many markets, talk of a lost generation. A generation that will fund many social programs in place today but not reap the benefits of those programs themselves. The ILO also estimates that around 45 million new jobs will need to be created each year just to keep pace with the growth in the global labor force.[3]

At the same time, the developed world has lost tens of millions of jobs. The developing world is struggling to harness expanding growth opportunities and cope with their growing populations. As an example, more than 50% of India’s 1.2 billion people and 60% of Africa’s 1 billion are 24 years of age or younger.

Worldwide, two billion children live in developing countries, with one in three never completing the fifth grade. Feeding and educating these children is more than a local issue; it has become a global health and economic challenge.

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[2] WEF International Business Council International Business Council Background Note prepared by the U.N.’s International Labour Organization, January 2010

[3] WEF International Business Council International Business Council Background Note prepared by the U.N.’s International Labour Organization, January 2010

In January, the United Nations Educational, Scientific and Cultural Organization, UNESCO, issued a report, Education for All-Global Monitoring Report 2010, on worldwide education.

They project that by 2015, 56 million primary school-age children who should be attending school will not be – and girls account for more than half of that number. Many of these children are in developing countries, but clearly not all.

These numbers show us that both developing and developed countries have significant challenges to educate and prepare skilled workforces in the decades ahead.

The impact of globalization – particularly the shift from west to east – is profound. It is hard to overestimate the impact of China on the global economy. Certainly, that impact is recognized here in Australia, where China has overtaken Japan as the largest export market.

The global economic recovery will depend on China and emerging markets continuing to develop their domestic economies – and the good news is that we are seeing the growth of the consumer not only in China, but also in countries such as Brazil and India. But the recovery is not just up to the developing markets; the developed market economies must get consumers back in the game by instilling confidence in the market, creating jobs and extending credit.

Our collective ability as a global society to meet the demands and challenges in both developed and developing countries is critical to a long-term sustainable recovery.

I am an optimist, and I believe there will be a new approach to solving these issues. Businesses will look beyond their short-term shareholder focus and recognize that they must look at the broader stakeholders. They must and will partner with NGOs and governments to form new ways to come together and create the path to address these issues and ensure a long-term sustainable recovery.

Technology advances will accelerate new business models will emerge. Innovation and investment is critical to making this happen, and we are seeing that begin.

As much as the trends I spoke about create tremendous challenges, they equally create unprecedented opportunities. And based on my conversations in Davos and with our clients, especially those I have met with in the last couple of days in Melbourne, there is good reason to be optimistic.

This brings me to my second point: how we and our clients are dealing with an “evolving” global regulatory environment.

We all know that trust is critical to making the capital markets work. Investors won’t invest until they trust the capital markets system; consumers won’t buy until they have confidence; and businesses won’t deal with each other, lend money, or make deals until they have trust in the system.

For business leaders, as well as governments, the current lack of confidence or trust in the capital markets and business in general is a major challenge. Let’s face it, in many places around the world the system let a lot of people down, savings were wiped out, retirement plans altered. One of the obvious outcomes of this situation is the call for stricter regulations. And after what we have gone through, that's understandable.

Regulation is more prescriptive now. Regulators around the world are defining the specifics on issues like capital requirements and much tighter liquidity requirements, mandating not only what to disclose but how to disclose it. They are taking positions as to what are acceptable business models or risks.

Tougher financial regulation is to be expected, and is called for as part of rebuilding trust and restoring confidence, but it must be designed and applied thoughtfully. I believe we need a global regulatory framework for our global complex institutions. I am not saying we need a single global regulator, but there needs to be a framework so the world is moving in a similar direction even though they may take different paths. A clear destination would be very constructive.

We all want the same thing, long-term sustainable capital and financial markets around the world. And I believe by coming together in groups like the G20 to focus on the issues, to share best practices, to learn from each other, we'll get to a reasoned solution, with a global framework and consensus for moving forward on key items.

But in developing this regulatory framework, I think we need to keep the following principles in mind:

- we do need global financial institutions with the resources to meet the highly complex needs of global companies
- at the same time, we must reduce the risk in the system
- we shouldn't take any actions that put the current fragile recovery in jeopardy
- and we must be thoughtful and not over react

I am encouraged by the work that has been going on with the G20 and the Financial Services Board. It could move regulators to focus not only on tactical country level views of compliance and regulation, but to also work across borders to a macro-prudential view to assess and monitor the strengths and vulnerabilities of the global financial system.

By bringing together national regulators from different functions – banking/treasury, securities markets and insurance – the FSB can reduce risks of regulatory arbitrage, both between countries and across industries. I believe that we have not yet seen the possibilities of the FSB, and I am watching with interest to see how that group and its work develops.

Let me turn to one specific issue being debated across the globe: "too big to fail." There is no question this must be resolved. On one hand, there is a need for large, global financial institutions that can serve the needs of large, complex global companies. On the other hand, when an institution becomes integrated into every part of the global capital system, it presents a systemic risk when it pursues more risky initiatives.

And we need to protect the system. There are many approaches being tried and debated. The U.K. FSA announced that they are pursuing a path that says that banks operating in the U.K. will be required to produce "living wills" to provide blueprints on how to wind them down in the event of financial difficulty. The documents would allow financial authorities to manage a bank's demise quickly if there's an issue.

At the end of 2009, a small number of major U.K. banking groups began to produce living wills as part of a pilot exercise intended to help the FSA develop policy in this area. In the U.S., a draft proposal to deal with "too big to fail" firms unveiled by the Treasury Department requires companies that can affect large parts of the system to abide by “heightened prudential standards.” These include leverage limits, liquidity rules and “living wills.” And the Volker Plan addresses this topic as well.

Of course, the caution here is to guard against requirements that compel institutions to keep so much capital on hand to hedge against excess leveraging that the industry becomes unattractive to new capital investors.

Regulatory bodies around the world are looking for a systemic and orderly answer to the “too big to fail” issue and that will be the hot topic for the near future. This is a worthy conversation and highlights the need for a global regulatory framework.

Which brings me to my third point: the accounting profession and how we are responding in this evolving environment.

This crisis reinforced something that we always knew:

- there is a need for an almost radical transparency in reporting to investors and to all stakeholders about a company’s performance
- we need to work together to make financial reports less complex and easier to understand
- we need a high quality set of global accounting standards as a key to global transparency

Let’s cover the last point. In the U.S., IFRS remains on the SEC’s agenda. Just last week, the SEC issued a statement affirming its support of a single set of global standards and pointed to IFRS as that set of standards. It also described a work plan for its staff to allow the SEC to make a final decision in 2011. Some of the SEC's points of emphasis include completing the current convergence work program, and supporting the IASB's independence and focus on investor needs. We certainly hope this work plan will support a positive decision for use of IFRS in the U.S.

Progress does continue to be made. Private companies in the U.S. are currently permitted to use IFRS, and we have seen a number of companies beginning to do so, including those that are subsidiaries of foreign IFRS parents and some Private Equity portfolio companies.

At KPMG, we’re currently working with a large number of U.S. companies as they assess their preparedness for converting to IFRS.

Last October, the IASB and FASB reaffirmed their commitment to the goal of converging their respective accounting standards in 2011. While they have differences to work through, this is also a positive step.

It is also encouraging that Asia will have a stronger role in the standard-setting process with the Asian-Oceanian Standard-Setters Group (AOSSG), which held its inaugural last November.

But much heavy lifting still remains. It is easy to agree that we should have a single set of high-quality global accounting standards, but we also must have a globally recognized, independent, well funded standard setting body free from political interference. There needs to be a process to reconcile differences and reach common solutions.

The current debate about how to classify and account for financial statement instruments and loan loss provisioning will be a great test to see if the FASB and IASB can reconcile their different approaches and reach an agreement to bring consistency to these accounting matters that are critical to investors across the globe.

Finally, let me touch on the other two points: financial statements and reporting.

Things have simply gotten too complex in my point of view. In fact, they are so complex and so voluminous that we run the danger of audit financial statements not maintaining their relevance to our most important user – the investor. For example, one of our global client's annual report included 15 pages on remuneration and another included an 11 page pension footnote!

The real users of audit financial statements are shrinking. Companies do not use them to manage their businesses. In many cases, management does not use them to explain their financial results and I believe many investors simply cannot understand them.

Instead, the companies focus on NON-GAAP measures in their press releases. A recent report from KPMG Australia showed that 84% of the top 100 Australian listed companies used a measure other than statutory profit to measure their performance. This showed that directors believe statutory profit does not provide all, and certainly not the best, information for investors to understand the operating performance of the company. We need to re-think financial reporting, remove the complexity and improve the transparency, and develop a disclosure framework, not increase the volume of disclosures.

If we do not, then the relevance of the audit financial statements will serve a smaller group of users, mostly regulatory and plaintiff counsel.

In the end, and most importantly I believe, the recovery will come down to all of us getting back to basic values and fostering highly ethical business cultures in each of our organizations.

Creating ethical cultures starts with each of us as leaders. We all need to recognize that our actions go beyond "me." They can affect the entire chain within a company and potentially the entire system. It requires each player to have a filter they must use to ask themselves: "Who is relying on me?" "Who am I accountable to for what I'm doing?"

Ethical cultures have a common framework built on trust, integrity and transparency, void of self-interest and grounded in the recognition of the responsibility that we all have to the sustainability of the capital markets and the communities in which we operate.

They are cultures that don't measure our actions merely on the fact that they comply with the 'letter of the law' or return to shareholders, but rather in the long term, such cultures must be grounded in these well-understood values. These are the same values that my profession strives to uphold, and while I did not have the privilege of personally knowing Ken Spencer, I am told he was a model for upholding such values.