Building trust in Financial Markets
Accounting and Moral Hazard

Hans Hoogervorst, Ken Spencer Memorial Lecture, Sydney, 10 April 2014

Introduction

Ladies and gentlemen, distinguished guests, I am greatly honoured to provide the 2014 lecture in memory of Ken Spencer.

Over the years there have been a few accounting innovators. Visionaries that also possess the necessary gumption to turn their ideas into reality. Their work endures long after they leave the stage. Ken Spencer was one of those people.

Although I never had the privilege of meeting Ken, he is one of the reasons why the organisation that I chair exists today. He had an intense commitment to the improvement of financial reporting, both nationally and internationally.

As well as being Chairman of the Australian Accounting Standards Board, Ken played a pivotal role in the creation of the IFRS Foundation and the International Accounting Standards Board. Alongside fellow Trustee Paul Volcker, he created the institution, arranging funding from around the world and appointing the original members of the IASB.

I have been told Ken Spencer was a straight shooter. He chose his words carefully, but never minced them. Ken passed away in 2004, but his legacy lives on. Ten years later, the mission of the IFRS Foundation that he helped to shape is shared by almost every country in the world. Today, more than 100 countries require the use of IFRS. Most other jurisdictions permit the use of IFRS in some shape or form.

We are not yet at the point where IFRS adoption is total and complete, but it is an impressive achievement in such a short period of time. Thanks to the efforts of Ken Spencer and those other pioneers in international accounting, today we are much closer to achieving that objective.

This brings me on to the topic of my address to you this morning, and that is the relationship between accounting and moral hazard.

Moral hazard

As you may know, I have spent a big part of my professional life in politics. I was a minister in several governments that had to bring the bloated Dutch welfare state under control. It was very difficult and sensitive work. We continually had to challenge the unrealistic expectations of the Dutch population of what the state could deliver.

So when I left politics in early 2007 to become Chairman of the Authority for the Financial Markets (AFM), the Dutch financial markets regulator, I thought I had seen it all. I was happy to leave the hectic world of politics behind me. Cheerfully, I entered into what I thought to be the relatively rational world of finance.

And then the financial crisis hit.

I must admit to having been largely naïve about the depth of market failures that I was about to discover in the financial industry. During the financial crisis, it became clear that the banking industry had become just as dependent on the state as the clients of the Dutch welfare state! The bonuses were many times higher than unemployment benefits, but in many cases they, too, turned out to be underwritten by the state.

The AFM also uncovered malpractices that were not directly linked to the financial crisis. Massive misselling of complicated investment products to unwitting consumers by respectable insurance companies. Lack of quality control in accounting firms. Severe cases of incomplete or misleading information to shareholders.

So the former minister who thought he had seen it all was profoundly shocked. And I must admit that I am still shocked as we continue to stagger from scandal to scandal in the financial markets.

At the root of all these problems lies the enormous extent of moral hazard in the financial markets. The capital and credit markets are rife with agent-principal conflicts. There is a high potential for conflicts of interest wherever people work with other people's money. Moral hazard becomes even bigger, when there is an asymmetry of information, when the agent has more information than the principal.

Lack of transparency is the scourge of financial markets. It is not just an inevitable by-product of the inherent complexity of products and markets. Opacity is sometimes actively sought to create opportunities for rent seeking.

In the post-war period, the potential for moral hazard has exploded as more people started working with more of other people's money. The leverage in the credit markets has increased exponentially. The financial crisis exposed the risks of a historically unprecedented credit boom, which led to banks being leveraged 30 to 50 times.

Secondly, the global capital markets have in the last 30 or so years nearly quadrupled in size relative to GDP[1]. A lot more money has become available for investment through institutionalized savings by pension funds, mutual funds and insurance companies.

---

[1] McKinsey & Company, "Global Capital Markets: Entering a New Era", *Insights and Publications*, www.mckinsey.com

With the increasing complexity of the economy, the distance between investor and investee has increased dramatically as well. Not many investors are capable of keeping a close eye on the managers they have entrusted their money to.

All this is an ideal backdrop for short-termism. Money managers have huge incentives for making momentum-driven investment decisions. In the short run, going with the flow is often the safest bet, no matter how irrational this flow may be. As long as the going is good, the money manager does not face criticism; when the music stops, he can blame it on the markets.

Third, performance-related pay has increased tremendously in listed companies. While this serves to align the interests of management with those of investors, it also provides an increased incentive for earnings management. According to a 2005 survey, more than 75% of the 400 business executives surveyed said that they would give up economic value in order to smooth earnings. These executives said this is mainly driven by a desire to satisfy investors[2]. But could it be that performance-related pay is also a powerful incentive for short-termism?

Accounting and moral hazard

Against this backdrop of moral hazard, what is the role of accounting standards?

According to our Constitution, the objective of the IFRS Foundation is "to develop, in the public interest, a single set of high quality, understandable, enforceable and globally accepted financial reporting standards based upon clearly articulated principles. These standards should require high quality, transparent and comparable information in financial statements and other financial reporting to help investors, other participants in the world's capital markets and other users of financial information make economic decisions."

Personally speaking, I prefer David Tweedie's much snappier version of this definition of the role of accounting being to 'keep capitalism honest'. Indeed, if I had to summarize the essence of our mission in five words, I would say it is "**building trust in financial markets**". The public interest in our work goes beyond serving the information needs of investors. We protect and strengthen the very fabric of trust in our market economies.

People sometimes tell us that we should not set our standards from an anti-abuse perspective. I do not agree with this view. I believe combating moral hazard is at the core of what we do. That is why our standards are all about discipline and rigour. Eliminating information asymmetry is the key to minimising moral hazard. We should be completely unapologetic about it.

[2] Graham, J R, Harvey, C R and Rajgopal, S (2005), "The Economic Implications of Corporate Financial Reporting", *Journal of Accounting and Economics,* 2005

Over the years, the IASB has built up an impressive track record in its efforts to combat moral hazard. I will give just a few examples.

Some years ago, the IASB and the FASB had the mother of all battles against vested interests to record the granting of stock options as an expense. There was a hugely expensive lobbying campaign to keep it that way. But there was one question that this lobby never could answer: if these stock options really cost nothing, why not give them to everybody? Almost ten years later and very few people question the logic of recording stock options as an expense. It is simply regarded as good business practice.

The same is true with pensions. In the past, companies were able to keep pension liabilities off the balance sheet. As is often the case, what is not measured is not managed. As a result, the management of some companies were able to literally give away the value of the company without shareholders knowing anything about it. At the time, bringing pensions liabilities on balance sheet was hugely controversial. Today, these liabilities are routinely discussed in the boardroom and with investors.

Today, we have a similar battle with leasing. The vast majority of lease contracts are not recorded on the balance sheet, even though they usually contain a heavy element of financing. For many companies, such as airlines and retail chains, the off-balance sheet financing numbers can be quite substantial.

Stripped bare, the leasing project is all about preventing the understatement of liabilities. Some might want to say it is about bringing prudence to lease accounting. Again, there is huge resistance against our bringing these liabilities to the balance sheet. I have no doubt that, five years from now, many will wonder what all the fuss was about.

Sometimes we did not get it quite right. A good example is the incurred loss model for impaired financial assets. The incurred loss model was developed to prevent earnings management by banks. Our predecessors wanted to prevent 'big bath provisioning' as they feared these provisions could be used to flatter earnings in bad economic times.

During the financial crisis, it became apparent that the incurred loss model could be used for another type of earnings management. The model provided legitimacy for delaying the recognition of losses when they had all but become inevitable. Our new expected loss model should put an end to this practice, while it still contains sufficient safeguards against earnings management.

Given our track record on instilling discipline and rigor, I am amazed by the sometimes virulent nature of the public debate on Prudence. As you may know, until 2010, our *Conceptual Framework* contained the concept of Prudence. It was defined as "the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such

that assets or income are not overstated and liabilities or expenses are not understated."

The IASB removed this concept, as some were worried that it was misunderstood and that it could conflict with the goal of neutrality. Ever since, Prudence has become an issue of controversy. Some have even gone as far as to claim that the act of removing the word Prudence from the framework in 2010 partly caused the 2007 global financial crisis. Go figure that one out!

I have said before that I believe the concept of Prudence still to be very much alive in our Standards. In our deliberations on the *Conceptual Framework*, the IASB will seriously look at the question whether to reinstate Prudence and if so, how.

But I also want to be clear about what Prudence as a concept can<u>not</u> mean. It cannot mean a return to old-fashioned accounting with hidden reserves. It cannot lead to a systemic bias toward conservatism that is at odds with neutrality. And as Warren McGregor recently pointed out[3], Prudence should never be a concept that is used to override our Standards. If a standard is not prudent enough, the standard should be changed. Finally, Prudence should not be invoked to create a taboo on using current measurement. There is nothing more imprudent than to measure derivatives at cost or to measure an insurance liability at historic interest rates.

If Prudence, on the other hand, is seen as congruous with our quest for limiting moral hazard and harmful earnings management, we have no issue with it and we should be able to give it its proper place.

Governance and moral hazard

Now I would like to make some observations about the implications of the issue of moral hazard to the governance and working methods of the IASB.

Some find it difficult to understand why an organization whose work has such a clear public interest function should be a privately organized. Given its public mission, would it not be logical if the IFRS Foundation and the IASB were public sector organisations? Does the fact that the IASB is privately organized not make it vulnerable to pressure from private interests? These are legitimate questions that deserve a serious answer.

First, I would like to point out that a public governance structure of standard-setting is in itself no guarantee for avoiding moral hazard. Take for example public sector accounting.

In most jurisdictions, the public accounting standards are set by public authorities. Whether these standards always lead to a complete picture of a country's financial position is in doubt.

---

[3] Jan McCahey, Warren J. McGregor: Prudence in financial reporting: virtue or vice? Commentaries on financial reporting #2, February 2014

The most obvious shortcoming in public sector accounting is the treatment of pension liabilities. There are only a few countries–such as Australia and New Zealand–that fully consolidate public sector pension obligations in the public accounts. Tellingly, these countries have made great progress in making their pension systems realistic and sustainable.

Most countries around the world, however, keep their pension liabilities off-balance sheet. Several studies have found these liabilities in many countries to be more than twice as big as the official public debt[4]. Full consolidation of these enormous amounts would make it immediately clear that these pension obligations cannot possibly be met without deep reform. As a former minister of finance I can assure you that the political incentives for keeping an inconvenient truth off the books are very strong indeed!

So, standard-setting in a politicised environment is very likely to lead to suboptimal results. The IPSASB Governance review group, chaired by the IMF and the OECD, recently noted 'that national standard-setters for the public sector are often inherently conflicted by the fact that they are working under the auspices of ministries of finance that are subject to these standards'.[5]

Around the world, accounting standard-setters are organized in different ways. Some are private, others are public. I strongly believe that the key to the success of a standard-setter is not so much the public or private nature of its governance. The key to being able to serve the public interest is its ability to fend off capture by special interests. The key to preventing moral hazard in standard-setting is to find the right balance between independence and accountability.

The governance of the IFRS Foundation has evolved throughout its 13-year history. We started in a purely private setting, but since the creation of the Monitoring Board our governance has a mix of private and public elements. Moreover, a large number of jurisdictions have public endorsement procedures in place for the adoption of our Standards.

I am sure our governance will continue to evolve in the years to come. But I am equally sure that the IASB already has first-class procedures in place to ensure our accountability.

Never before in my public life have I worked in an environment that is as transparent as ours. Our due process is first-rate and is monitored continually. All of our standard-setting activities and papers are open to the public.

The recent creation of the Accounting Standards Advisory Forum has further enhanced the inclusiveness of our work.

[4] E.g. see: Reimund Mink (ECB), General government pension obligations in Europe. IFC Bulletin no. 28, 2008
[5] The Future Governance of the International Public Sector Accounting Standards Board (IPSASB). Public Consultation, January 2014

But in order to fend off special interests, we also need our independence. We are not asking for unfettered independence, but we need to be shielded from politicized processes dominated by special interests. We need to be able to draw a line between listening to our constituents and being overly pressurized by specific interest. Our independence is not there to protect the IASB, but to protect the quality of our work.

Conclusion

Ladies and gentlemen, I will now draw to a close.

The central theme of my speech was moral hazard and what to do about it. Moral hazard was the root cause of the global financial crisis. The global financial crisis has shaken trust in our market economies and its institutions to the core. The economic and political repercussions of this loss of trust will be felt for many years to come.

The mission of the IASB is to build trust in financial markets. With the spread of IFRS around the world, we have come a long way in fulfilling this mission. But our mission is not complete. Some very significant jurisdictions still have not adopted or completely adopted IFRS. That is why we need the continued support of the G20 for a single set of global accounting standards.

As the current President of the G20, Australia is very well placed to help us bringing our mission forward. It is not a goal that can be fully accomplished during your presidency. But you can do a lot to keep this long-term project going. As Theodore Roosevelt once famously said, nothing in the world is worth having or worth doing unless it involves effort, pain and difficulty. We are happy to share our pain with the Australian government and count on your support!