STANDING GUARD FOR STANDARDS

Can you trust the numbers? Accounting standards exist to give investors confidence in the figures, but can you trust the standards? While a global economy demands unified standards, can such a thing really exist?

Facing tough questioning from Brunswick's Andrew Garfield, the Chairman of the International Accounting Standards Board, Sir David Tweedie, believes so

CONVERGENCE

Andrew Garfield: How much of a challenge do the rising nations of Asia and Latin America pose to the Western view of published accounts as a "true and fair" measure of a business, given their different cultural values and attitudes regarding transparency, disclosure and obligations to stakeholders, particularly financial investors?

David Tweedie: There's no one view of accounting across Asia and Latin America, but neither is there across western Europe, and there is support for International Financial Reporting Standards (IFRS) in all of these regions. This support exists because, in many cases, these economies have suffered a lack of confidence in their reporting regimes. Asia, in particular, had its own financial crisis in the 1990s, as did Argentina and Brazil. Adopting IFRS, with their investor focus and transparency, helps remove the risk associated with investing in these countries.

Can we really bridge the cultural gulf that exists between Europe and the US, and how problematic will it be if European and US bodies cannot agree a unified standard? Would it be better for them to go their separate ways than settle for a compromise that pleases no one?

I just don't buy the argument that the US should account for the same transaction differently from the rest of the world. The financial crisis blew that argument away. The fallout from Lehman Brothers affected world markets because equity and debt markets are so tightly coupled. Combining global markets and regional accounting standards invites regulatory shopping, as seen with the "Lehman Repo 105" problem [the accounting device that helped Lehman Brothers conceal its high leverage]. That is why the last three G20 communiqués have called for the International Accounting Standards Board (IASB) and the United States' Financial Accounting Standards Board (FASB) to complete convergence by 2011, and for the world to embrace global standards.

We are on track to complete this work by 2011 – the date when the US will decide on domestic use of IFRS. The Securities and Exchange Commission (SEC) has long supported IFRS, and I remain optimistic that the US will sign up to them in the near future.

It seems the US has stepped back from "fair value accounting," where the value of assets or liabilities is based on current market price rather than original cost, while many European corporations argue such practices are only valid for short-term trading books and that they are misleading when evaluating the strength of longer-term investments or assets. Does this mean the IASB, in advocating this model, is out of step with the principal users of accounts?

The FASB has proposed a full fair value model for all financial instruments, so it is wrong to say the US has stepped back. Meanwhile, the IASB has issued *IFRS 9 Financial Instruments*, which applied a "mixed measurement model" for financial instruments. Basic loans with predictable cash flows would be measured at cost; anything traded, or more exotic instruments with unpredictable cash flows, would apply a market price. Most commentators support this approach, which it is estimated will reduce the use of fair value by most financial institutions.

EFFECTIVENESS

One problem with accounts is they are backward-looking when most users want to know about future performance. Isn't this something your standards should address?

That's not strictly true. For example, *IFRS 9 Financial Instruments* takes into consideration predictability of future cash flows. But there are limitations to the information that can or should be in reports, and investors tell us they do not want forecast information in statutory accounts.

Should there be a uniform standard for industries as diverse as airlines, packing companies, chemical industries and banks, or should we recognize different businesses have different performance drivers?

If you apply different reporting requirements by industry, you tie yourself in knots. Is Tesco a financial services company, a retailer or a commercial property business? The answer is probably "yes" to all, so how would you apply sector-based standards?

In some cases, there are specific issues to be dealt with by a separate accounting standard, but we work hard to avoid defining them as sector-specific. That is why we have proposed accounting standards dealing specifically with insurance contracts and extractive activities – defining function, not sector.

Do you think some users place too much faith in published accounts and should be aware of the limitations of accounting?

Yes. And that was a conclusion of the Financial Crisis Advisory Group, a group of business leaders and policymakers advising the IASB on its response to the financial crisis. Sophisticated investors see published statements as a source of evidence, not answers. Other sources that should be consulted include market data, industry statistics and economic forecasts.

Is it true that as soon as management or investors focus on just one metric, it ceases to be meaningful?

I've always likened the bottom line to a haggis – if you knew what was in it, you wouldn't touch it with a barge pole. You get a more accurate impression of the wellbeing of a company by also considering current trading, stripping out unusual items, as well as long-term gains and losses.

Accounting standards reform is supposed to have improved transparency and disclosure, but the feeling persists that no one really knows what goes on inside financial institutions. Doesn't that suggest something is wrong with the approach to standards?

I have some sympathy with people who say that standards are complicated. But remember, the IASB has been around for less than 10 years, and the international standards that we inherited were roundly condemned when we acquired them. In that time we had to patch up existing standards as best we could

SHARED VALUES PAY DIVIDENDS (AT THE CO-OP)

As financial institutions look to rebuild trust among all their stakeholders, they could benefit from adopting the values of organizations owned by their "members," says Neville Richardson, Chief Executive of Co-operative Financial Services (CFS).

"Every organization has values, and they drive how that organization behaves," Richardson says. "But because Co-operative Financial Services is owned by its members and customers, not by other financial institutions, those members play a more active role in shaping our values, social goals and ethical agenda."

CFS is a diversified mutual business operating in both retail and corporate markets whose brands include the Co-operative Bank and Britannia. The combined business has £70bn in assets, 12,000 staff and 9m customers.

It is part of the UK's Co-operative Group, the world's biggest consumer-owned business with 5m members, 5,000 retail trading outlets and a turnover of £14bn ($22.5bn), with core businesses in food, financial services, travel, pharmacy and funeral care.

"The Co-operative is not simply profits-driven, but places equal emphasis on customer, social and employee measures, as well as on making profits to reinvest, share with members and invest in society," says Richardson.

Co-operatives started as grass-roots groups in western Europe, North America and Japan in the mid-18th century. The modern movement was created in 1844 by a group of weavers in northern England who, oppressed by poor working conditions and low pay, banded together to obtain basic goods at lower prices.

The idea of every customer becoming a member with a stake in the business was soon introduced, and it's a system which remains today. One and all members have a vote on key decisions.

"Our structure of regional boards and area committees enables members to hold us to account, while our customer engagement model enables customers to challenge us in preparation for more than 100 countries using them, and prioritize our response to the worst economic crisis in more than 80 years.

The new standards that we and the FASB have written from scratch will come into effect in the next few years and will strip out much of the complexity that you refer to. Clearly there is more to be done, but that will be the job of my successor.

FINANCIAL TURBULENCE

Many critics, particularly in continental Europe, feel the drive toward fair value accounting, arguably at the heart of the international standards, was a big factor in the instability that caused the credit crunch. What lessons can be learned?

It's a myth that fair value accounting is at the heart of IFRS. The IASB has introduced little of it and, where we have done so, it has largely been in response to requests from practitioners.

Also, while fair value accounting is not perfect, it's not the villain many claimed. Post-crisis analysis has shown that poor lending decisions, lack of risk management, over-leveraging and insufficient bank capital requirements, the complexity of financial instruments, and a lack of due diligence also all contributed.

And studies from the Bank of England, Federal Reserve of Boston, and the SEC, have actually concluded that the role of fair value accounting was minimal. That's not to say such accounting was perfect and we are working on enhancements to improve transparency and disclosure.

Critics say the profession has failed to rise to the challenge posed by, for example, derivatives, whose volatility and destructive power cannot be captured by the traditional "snapshot in time" approach at the heart of accounting practice since the introduction of double-entry accounting.

Derivatives must already be disclosed under our rules. For example, the previously mentioned Lehman Repo 105 scheme would not have been permitted under existing IFRS, let alone the new enhanced disclosures we have recently proposed for off-balance sheet activities. That is one of the benefits of principle-based standards – we're never going to be able to predict every scheme dreamed up by the Ph.D. rocket scientists at the banks, but a well-crafted, principle-based standard will do a better job of catching them than detailed rules.

THE PROFESSION

Accounting can seem arcane even to sophisticated business people and investors. Do accounts really matter? Are accountants guilty of obsessing about footnotes and missing the big picture?

A former Chinese prime minister once told me that embracing international standards was one of the most important policy decisions of recent times. He felt to understand the bigger picture, you needed to

directly and provide feedback on policy and service," Richardson explains. As a result, the Co-operative Group regularly tops polls for customer satisfaction and fair employment practices.

"Uniquely, our board consists of executives, professional non-executives and elected lay members, a mix that ensures customers' and members' interests are at the forefront of decision-making," says Richardson.

He firmly believes the financial crisis might not have been so damaging had other institutions followed a similar, balanced approach. And that, he says, provides an opportunity for the current UK banking industry.

"Given that two of Britain's largest banks are effectively in public ownership, we surely have a unique opportunity to instill new values that put customer and social considerations high on their agendas.

"The Co-operative has become a market leader in financial inclusion, financial literacy, ethical investment, climate change and international development. We are determined to live up to that hard-won reputation: it's not window dressing, but part of who we are and what we do.

"And it is also part of our bonus system, another area where other banks could learn from what we do. Our approach is to use a balanced scorecard – my remuneration depends on the achievement of stretch targets in customer, social, colleague and financial measures.

"None of this deters commercial success; rather it supports and enables it, reflecting our purpose of being a pioneering business, delivering sustainable financial services for members and society for more than 150 years."

Neville Richardson became Chief Executive of Co-operative Financial Services following its 2009 merger with Britannia Building Society, a mutual savings and loans bank.

have confidence in the detail. Northern Rock [the UK lender] underlines why details are important – its disclosures showed that almost 80 per cent of its funding needed to be renewed every three months. A big-picture view helps, but the adage that "the devil is in the detail" is equally true for reporting.

Do these issues matter to anyone besides accountants?

Financial reporting is the universal language of business, so it does matter. However, it is sometimes difficult for those outside the profession to get to grips with such a complex and technical subject. But this is an area we have spent a lot of time on and, as a result, we are able to involve more policymakers, investors and business leaders.

Given what you say, shouldn't these people be actively involved in setting standards?

Yes, and this is something to which the IFRS Foundation trustees have given priority in their appointments to the IASB and its various advisory bodies. You do need some people on the board who understand the business of setting accounting standards, but more recent appointments to the IASB have included three former investors, two regulators and two former CFOs; and my successor, Hans Hoogervost, a former politician and regulator.

TRUST

Don't events, like the sub-prime mortgage crisis, demonstrate that accounts only measure what accountants are comfortable measuring and are poor as a true measure of a business's health?

The accounts should reflect the economics which, in some cases, are simple, have predictable cash flows and are relatively easy to measure.

However, the financial crisis was triggered partly by horrendously complex financial instruments no one could measure. How can you reliably measure a collateralized debt obligation containing other collateralized debt obligations that have sliced and diced thousands of sub-prime mortgages?

Accounting cannot and should not mask this complexity. There is no alternative to market-derived measurement for such complex products and, even then, potential investors should scrutinize them before making investment decisions.

How do you feel about managers who abuse accounts – even when they aren't engaged in actual manipulation – and who focus on delivering a few easily measurable indicators at the expense of the business's long-term health?

There is an overlap between financial reporting and corporate governance and we are happy to plug loopholes where we see continued abuse of standards. Research shows that many "long-term" investors churn their investments several times a year, so short-term performance measures clearly matter to many investors.

Do IFRS accounts skew managers' priorities to indicators that don't necessarily correspond to the business's priorities and add running costs while benefiting accountants?

Our starting point is to consider whether the change will result in more useful information being made available to users of financial information. We then work backward to consider if the change warrants the increased burden on preparers, the profession and others. All our standards go through extensive consultation. Then the board explains how it responded to this feedback. We'll re-examine how the standard is functioning after two years; if we got the balance wrong, we'll look again.

How can accountants restore trust in corporate accounting?

Corporate reporting is based on the accounting standards and the ethos of company law. The true and fair view is evolutionary. What was true and fair 20 years ago would be unacceptable today. Trust comes from good accounting standards, tough auditing and effective regulation – all this in an atmosphere of good corporate governance.

Sir David Tweedie has been Chairman of the International Accounting Standards Board since 2001, having previously led the UK's Accounting Standards Board. The IASB is an independent, privately funded body based in London that develops and promotes accounting standards.

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Gill Ackers and **Pip Green** also contributed to this article.