The Road to Europe – Restoring Trust

Pristina, Kosovo
12 May 2011

John Hegarty
World Bank Centre for Financial Reporting Reform
The simple logic

“No transparency, no trust;
no trust, no credit;
no credit, no investment;
no investment, no growth!

So there is a simple logic: financial reporting is an essential building block for financial intermediation, foreign investment, and sustainable economic development.”

Martin Gruell
Raiffeisen International
The global financial crisis: A loss of trust

Credit is trust: the credit crunch is a breakdown of trust

» Trust between banks and households: the sub-prime crisis

» Trust between banks: the seizing-up of inter-bank markets

» Trust between banks and investors: collapse of bank equities

» Trust between companies: cut-backs in trade credit

» Trust between countries: reversal of cross-border flows

» Trust between governments and accounting standard-setters

» Trust between users and the audit profession
Causes of the global financial crisis

At the root of market failure was optimism bred by a long period of high growth, low real interest rates and volatility, and policy failures in:

- **Financial regulation**, which was not equipped to see the risk concentrations and flawed incentives behind the financial innovation boom

- **Macroeconomic policies**, which did not take into account the build-up of systemic risks in the financial system and the housing markets

- **The global financial architecture**, where a fragmented surveillance system compounded the inability to see growing vulnerabilities and links

**Implications for financial reporting.** Not the major cause, but clear room for improvement
Financial reporting
A fundamental foundation
The Road to Europe - Restoring Trust

Importance of high quality financial reporting

ECONOMIC GROWTH

Development of Capital Markets

Accounting and Auditing

Financial Stability

Financial Information

Improved Access to Credit

Financial Sector Development

Private Sector Growth

Job Creation
It’s not just about IFRS and ISA ...
... but about strengthening all the pillars ...
... a broad vision of financial reporting ... 

High quality financial statements that meet the needs of:

» Current and potential owners/investors
» Other providers of finance
» Tax authorities
» Other regulatory and supervisory authorities
» Those responsible for national statistics and macro-economic data
The Road to Europe - Restoring Trust

... built on a single foundation ...

- Financial reports for taxation purposes
- Financial reports for prudential regulation
- Financial reports to lending banks
- Financial reports to capital markets
- Financial reports as the basis for national statistics

Accounting & Auditing


... and linking the needs of different users

- Investors and creditors in capital markets
- Lending banks
- National statisticians
- Tax authorities
- Prudential regulators
- Public interest
Financial reporting: Lessons learned from the crisis

» **Market discipline didn’t work**
  » Serious questions about the agency model
  » Prudential supervision (micro and macro) has an indispensible role
  » Why should markets and regulators want different information? Who knows best?

» **Even if it didn’t cause it, financial reporting facilitated procyclicality**
  » Financial reporting is not neutral – hard-wired into regulatory systems, contracts, incentives
  » Risks not understood or reflected

» **Standard-setters underestimated their systemic role**

» **Where were the auditors? Where was the profession?**
Have accountants and the profession been left behind?

- Intense pressure from the G20, FSB, BCBS, EU
- IASB has not yet delivered on its G20 mandate
- IASB-FASB convergence not yet done
- 2011 deadline slipping
- Basel III did not wait for resolution of fair value and loan loss provisioning debates
- No convincing proposals from the profession to reform audit
  - Leadership being taken by the regulatory community (e.g. European Commission Green Paper)
- Increased questioning of the quality of “traditional” audits
- Beware the fate of the Credit Rating Agencies
Governments take the lead

- G20
- Financial Stability Board (FSB)
- World Bank* and IMF*
- Basel Committee on Banking Supervision (BCBS)*, International Association of Insurance Supervisors (IAIS)*, International Organization of Securities Commissions (IOSCO)*
- European Commission*
- International Forum of Independent Audit Regulators (IFIAR)
- Monitoring Group (WB, EC, BCBS, IAIS, IOSCO, FSB, IFIAR (observer))
  - Public Interest Oversight Board
  - IAASB (Auditing), IESBA (Ethics), IAESB (Education) / Related CAGs
  - International Federation of Accountants (IFAC) / PAODC
- Monitoring Board (IOSCO, US SEC, Japanese FSA, EC, BCBS (observer))
  - IFRS Foundation
  - International Accounting Standards Board (IASB)* / IFRS AC / SME IG / IFRS IC
* FSB Member
The G20 foreshadows the planetary governance of the 21st century. It symbolises the return of politics whose legitimacy was denied by unregulated globalisation.

Without the G20, it would not have been possible to envisage regulating bonuses, closing down tax havens and changing the rules of accounting and prudential standards.

And how can we hope that people will continue to trust the word of States if the commitments made are not kept?

If the absolutely crucial debate on accounting standards gets bogged down, if the private agencies to which we have delegated regulatory power deliberately flout the mandate given them by Heads of State and government, and we let them get away with it, what will be left of the credibility of the G20 and the prospect of world governance?
Impacts on financial reporting (1/2)

» Rebalancing the priorities of financial reporting

» Rediscovering prudence and regulatory relevance

» Continuing pressure for further reforms of the IASB

» Somewhat unfair to blame the IASB for failing to reach agreement, when those calling for action cannot agree among themselves?

» Greater integration with, and accountability to, the broader global system of financial regulation: traditional “independence” an unhelpful concept

» Where do we stand on convergence?
  • Will the US proceed urgently with the SEC roadmap?
  • What will the EU do if the US stalls?

» Watch for indications of change under the new IASB leadership
Impacts on financial reporting (2/2)

How does the audit function fit in the new landscape?

- Getting the traditional financial statement audit right
  - Audit inspection reports of concern: tone at the top, tolerance of failure
  - Remember who the client is
  - Expanded links between the auditor and prudential regulators
  - More informative audit reporting; greater auditor transparency
  - Increasing trend to reduce the statutory audit requirement
  - What can assurance providers offer instead?

- Beyond the traditional audit
  - Stewardship and sustainability
  - Can the audit be expanded beyond the micro only?

- Further reforms of IFAC’s standard-setting activities
- Competition and choice; diversity to reduce systemic risk
- Rediscovering the role of the profession
Kosovo: On the Road to Europe

» Planning for the journey ahead, while celebrating the distance already travelled

» Establishing reputation and trust

» Aligning systems of domestic regulation with the imperatives of EU requirements and of globalized markets and market participants, while still responding to today’s local realities

» Implementation at national level: standards, institutions, capacity, compliance, and European/international cooperation

» Relationship between the profession and the state
The simple logic

“No transparency, no trust;
no trust, no credit;
no credit, no investment;
no investment, no growth!

So there is a simple logic: financial reporting is an essential building block for financial intermediation, foreign investment, and sustainable economic development.”

Martin Gruell
Raiffeisen International
Strengthening the pillars

- Accounting Standards
- Statutory & Governance Framework
- Professionalism & Ethics
- Education & Training
- Monitoring & Enforcement Institutions
- Auditing Standards
Concluding Remarks