



**“THE LIMITATIONS OF ACCOUNTING MODELS AND THEIR  
IMPACT ON DECISIONS”**

**IEA/MARKETFORCE CONFERENCE ON THE FUTURE OF THE  
FINANCIAL SYSTEM**

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**Introduction**

Ladies and gentlemen, it is a pleasure to address you at this conference on the future of the financial system. I am Chief Executive of the Financial Reporting Council, the UK’s independent regulator responsible for promoting confidence in corporate reporting and governance. The FRC has a broad range of responsibilities, including maintaining the Combined Code on Corporate Governance, monitoring compliance with the accounting and auditing requirements of the Companies Act and oversight of the accountancy and actuarial professions. Most of our activities are undertaken

by our six operating bodies, including the Accounting Standards Board (ASB). My remarks today, however, are personal reflections and do not necessarily reflect the views of the FRC Board or the ASB.

The topic which I have been asked to address is the limitations of accounting models and their effect on decisions. I am proud to be a professional accountant but I am also very conscious of the limitations of accounting.

I have organised my thoughts for today into four sections:

- The purpose of accounting and the scale of the accounting challenge.
- Do we need accounting standards and who should set them?
- The impact of accounting on decisions.
- Accounting aspects of the current financial crisis.

### **The purpose of accounting and the scale of the accounting challenge**

Accounting is integral to the structure of business in the UK and in many countries around the world. It is directly related to the ability of business to organise itself by means of limited liability organisations. The invention of the limited liability company in the mid 19<sup>th</sup> century was one of the most

important enablers of the industrial revolution because it encouraged entrepreneurs to take business risks on a scale which they were not previously prepared to do when they were personally liable for the debts which they were responsible for incurring.

But Parliament decided that there should be a price for this privilege: limited liability companies would be required to prepare and publish accounts (or, as they are now normally more commonly described, financial statements) and that those financial statements should be audited. It is worth noting that the obligation to prepare financial statements was a price that had to be paid by the shareholders (ie out of the assets of the company which they owned) but the intended beneficiaries were the other stakeholders in the company such as its current and potential creditors and employees.

These requirements have, with a few minor modifications, remained in place for 150 years and are now expressed in the Companies Act 2006. The Act requires directors to prepare financial statements which give a true and fair view of the state of affairs of the company at the end of the financial year and of the profit or loss for the financial year. For companies which are

required to prepare their financial statements under international accounting standards there are similar requirements set out in an EU Regulation.

The advent of public equity markets was a subsequent innovation which enabled a further expansion of the scale of business risks as it enables companies to take business risks on a scale which the promoters of companies were not prepared to do when they were responsible for providing all of the capital. The legal obligation on companies to prepare financial statements was not changed but there was an important change in the economic purpose of financial statements: the shareholders became one of the beneficiaries (although they still had to bear the cost).

Arguably this revised economic purpose of accounting *to* shareholders has now become more significant than the original purpose of accounting on *behalf of* shareholders.

The challenge of giving a true and fair view of a company's financial position and results is an extremely demanding one. If you consider the challenge of providing a true and fair view - on paper - of one of your parents or children it can readily be seen how limited is the understanding of

their skills and personalities that can be conveyed on paper. There are so many aspects of a human being that it is difficult to decide which aspects to attempt to capture and which techniques would be most appropriate. A photograph? A medical record? A school report? A letter in their own hand-writing? A greater depth of understanding could be conveyed by a video clip but even then it would fall a long way short of conveying the full complexities of those individuals. The choice of aspects and techniques might well depend on the intended use to which the information is to be put.

The scale and complexity of the most important public companies is such that their financial statements are the product of very considerable simplification and summarisation of their activities. A great deal of skill and experience is required to prepare financial statements which give a true and fair view. But even properly prepared financial statements have considerable limitations.

### **Do we need accounting standards and who should set them?**

Over time it has come to be accepted that defining how directors should prepare financial statements solely in terms of a high-level principle (eg give

a true and fair view) is not an effective mechanism of achieving adequate accountability of companies. More detailed specification of what is required in order to give a true and fair view has been called for and provided in the form of accounting standards. The bodies charged with setting accounting standards also face considerable challenges in specifying what aspects of companies should be conveyed and which techniques would be most appropriate, particularly in view of the enormous diversity of companies which have to apply the standards.

The UK Accounting Standards Boards (ASB) and the International Accounting Standards Board (IASB) have both published statements which explain what they consider to be the objectives of accounting which they have in mind when they make their decisions on the content of the accounting standards which they publish. The ASB's Statement of Principles for Financial Reporting says that the objective of financial reporting is to:

“provide information about the reporting entity's financial performance and position that is useful to a wide range of users for assessing the stewardship of the entity's management and for making economic decisions.”

The objectives which the IASB has in mind are very similar, although there are some differences of emphasis which I will not dwell on today.

Both Boards recognise that there is a wide range of potential users of financial statements and that these users have a potential large number of differing decisions which they may have to take about the entity (eg buy, hold or sell its shares, become an employee or cease to be one, extend credit to, or withdraw credit from, the entity). Although it would be possible to prepare different financial statements for each category of potential user, which captured different aspects of a company or used different techniques to do so, the judgement has been made that the needs of these different categories of user are sufficiently similar that it would be disproportionate to require companies to do so.

However, the proportionality-based decision to have a single set of multi-purpose financial statements has certain consequences. Firstly, the effort to satisfy the information needs of a wide range of users within a single accounting model will mean that almost all users of financial statements will find that the statements contain some information which they do not find

useful. Secondly, not all of the needs of all users can be provided by a single set of financial statements. Not everyone can afford to have a tailor-made suit!

The FRC has recognised that there are widespread concerns about the complexity and relevance of financial statements and we have been working on a project to clarify the nature of the problem and to identify potential ways of alleviating it. We shall be publishing a paper on this subject later this month and we hope that it will be widely read and commented on.

There are, of course, special categories of user of financial statements (for example the tax authorities and the financial regulators) who have legal powers to require companies to provide them with precisely the information which they require for their particular information needs. These users can insist on having tailor-made suits if the issues for which they have responsibility are sufficiently important.

It is unsurprising that this should be the case because the general purpose financial statements which are the product of applying accounting standards are unlikely to be wholly suitable for raising taxes, or determining how

much it is prudent for a bank to lend. General purpose financial statements are even less likely to be suitable instruments for contributing to macro-economic stability, an aim which some people have advocated assigning to accounting.

If there is a wish to use accounting to achieve policy aims for which it is not designed then this will have implications for the current uses of accounting. It is essential that there is a thorough and public debate about any such changes so that the advantages and disadvantages can be properly assessed and compared to the other options available for achieving those policy aims.

There are a wide range of sincerely held views about the merits of different accounting methods, and judgments have to be made as to which methods best meet the needs of the constituencies that have to apply them, audit them and make decisions based on them. There are, for example, questions about the boundaries of the organisation as reflected in consolidated financial statements: what degree of certainty is required before an asset or liability can properly be treated as off-balance sheet? There are questions about the most appropriate basis for measuring assets and liabilities. Accounting

standards must benefit from the input of all constituencies and to this end, due process is critical.

We at the FRC believe that the most appropriate standards are likely to be developed if standard setters are able to exercise independent judgment, relying on their skills and experience. The standard setters must be independent of all vested interests. Whilst we recognise that politicians have a responsibility to ensure that there is an effective system for setting accounting standards we believe that the choices as to the most appropriate accounting methods should not be made on political grounds.

### **The impact of accounting on decisions**

Accounting is, therefore, a legal construction but it is one which clearly has economic consequences. One of the criticisms that is sometimes levelled at accounting is that it influences decisions, that people make decisions on the basis of accounting information. This is a surprising criticism: the purpose of accounting is to be useful for decision-making!

It is not surprising that investors should decide to invest more in those companies whose financial statements show that they are profitable than they invest in those companies whose financial statements show that they are loss-making. It is not surprising that board should decide to allocate more capital to those operating divisions whose financial statements show that they are profitable than they allocate to those operating divisions whose financial statements show that they are loss-making.

Those people who level this criticism at accounting frequently do not like the implications of the accounting information for the decisions with which they are faced or the impact which it has on the evaluation of decisions which they have made in the past. The critics of accounting frequently seek to dismiss accounting as being:

- **Backward-looking**, despite the fact that many of the most critical decisions in preparing financial statements involve judgements about the likely course of future events (eg the collectability of debts, the saleability of inventory, etc).
- **Based on an assumption of efficient markets.** This is not correct. Accounting does not assume that markets are efficient but it does assume, in relation to those assets which are required to be marked to

market, that in most cases markets are more objective than company management.

- **A snap-shot.** This is a strength of accounting rather than a weakness. The long-run is made up of a series of short-runs and it useful to have feedback on the results of each short-run. This does not, however, imply that accounting encourages businesses to be managed for the short-run. I like the analogy of the 70 lap Formula 1 Grand Prix. It is useful for the drivers to know their lap times and how much fuel they have left at the end of each lap. But it would be very unwise for a driver to conclude that his objective should be to drive a single lap in the fastest possible time without regard to its impact on his ability to finish the race.

However, there are some limitations which users of accounting information need to recognise. Firstly, it would be unwise to base a decision solely on accounting information; it should be one of many inputs to decision-making. Secondly, it is important that people who chose to rely, even in part, on accounting information take appropriate care to understand the basis on which the financial statements have been prepared.

For example, it is not necessarily wise to pay out bonuses on the basis of mark-to-market gains in rising markets which may not subsequently prove to be convertible into cash. The people responsible for the design of a bonus scheme are an example of a special purpose decision-makers for which the information in general purpose financial statements may not be appropriate. Their needs are more likely to be met by the preparation of specific information on which the bonus schemes should be based than by changing accounting standards. This is the approach which has been taken recently by my colleagues at the Financial Services Authority in their draft Code of Practice on remuneration policies for large financial services companies.

It is also the case that since the accounting standard setters have no control over the decisions for which accounting may be an input it is not reasonable to require them to base their decisions on the choice of accounting methods on an assessment of the impact which accounting will have on decision-making.

## **Accounting aspects of the current financial crisis**

One of the indicators of a financial crisis is a sharp increase in the number of references to accounting techniques in newspaper columns. One of the indicators of a *serious* financial crisis is a sharp increase in the number of references to accounting techniques in speeches by politicians. By these measures, ladies and gentlemen, it is clear that this is indeed a serious crisis!

There have been some criticisms of accounting during the recent financial crisis and those will have to be carefully considered. My remarks this afternoon are intended to be a contribution to that consideration.

I am not yet convinced that the criticisms of the role of accounting in the current financial crisis are coherent. The number of criticisms that the financial statements of financial institutions have overstated their losses arising appears to be closely matched by the number of criticisms that they have understated the losses.

For example, it was fashionable, in some quarters, this time last year for people to argue that mark-to-market accounting was inappropriate and gave

the “wrong” answer. The basis for this criticism was that the market prices were “wrong” and that the assets were really worth more than the market believed. Well, one year on we can see that in many cases the market prices were indeed wrong: the assets proved to be worth even less than the market indicated a year ago.

One of the characteristics of the growth of the financial services industry in recent years has been the extraordinary speed and range of innovation in products, services and indeed in organisational structures through which financial services are delivered. For some time innovation in financial services was regarded as being unquestionably a “good thing”. The credit crunch has led to this proposition being called into question.

There are questions about whether accounting techniques have been able to keep up with the rate of innovation. For example, there clearly are implementation issues in those cases where there is not a liquid market. But some of the innovation has been motivated to achieve regulatory arbitrage, such as exploiting the large difference in the capital requirements which apply to those assets required to be held in the banking book compared to those which could be held in the trading book. It is not surprising that this

has resulted in some accounting awkwardnesses. However, as my banking regulatory colleagues have recognised the most appropriate solution to this is to change the capital requirements rules.

Some commentators have also criticised the accounting standards boards for increasing the requirement to use mark-to-market accounting in recent years. It is true that there has been an increase in the use of mark-to-market accounting in recent years but the principal explanation for this is that many banks have chosen to increase substantially their investment in those categories of assets to which mark-to-market applies.

Mark-to-market accounting is an issue which has generated a lot of controversy in the last year or so and on which there appear to be very strongly held but opposing views. The critics of mark-to-market accounting have typically argued that it is a bad thing and should be stopped without going on to articulate what would be a better method of accounting for these assets and liabilities.

As a broad generalisation the management of banks are keen to have greater flexibility to depart from the mark-to-market requirement as they believe

that the market values are not representative of the intrinsic value of the assets (although these points were made with much less force during the years in which markets were generally rising) whereas investors are not enthusiastic about the use of mark-to-model (or, as we should perhaps call it, mark-to-management) techniques.

In truth it is hard to be sure which of these two views is the most accurate. Perhaps we should consider whether investors would find it useful to have disclosure of both market and model valuations. Given the uncertainty around the valuation bases, investors may also find it useful to information in future periods to help them assess which is the more reliable measurement basis. This could be done, for example, by requiring the disclosure in subsequent years of the difference between the proceeds for assets which have been sold and the market and model valuations at the previous year-end. This would also provide an incentive for management not to be too aggressive in the assumptions used in their models. There may also be other methods of conveying this information to investors.

Some commentators might argue that it is confusing to present users of financial statements with information on two different bases. However,

there are precedents for doing so. One example is the supplementary 'embedded value' disclosure insurers give on their with-profits life assurance business. This includes in the profit and loss account the present value of the future income that is expected to arise on the current book of life assurance contracts, using best estimates of how many policyholders will continue their policies to maturity and how many will surrender policies early.

This basis contrasts with the IFRS financial statements for insurers, which exclude future premiums. Whilst this is clearly a more restricted perspective than that afforded by embedded value approaches, it does provide information about the position at the balance sheet date resulting from past transactions. This is likely to be helpful in forming a basis for future forecasts, and also provides information about the extent to which previous forecasts (including management's own forecasts) have been met.

Analysts find value in the embedded value figures as well as the IFRS amounts because they are more directly related to the cash flows the insurer is expecting to get from the current book of policies (but note that they do not include expectations of new policies yet to be written, so they are not the

full expected future cash flows). However, there is great subjectivity and judgement involved in measuring these expected values – not only in assuming future investment returns (dependent on future investment strategy as well as market conditions) but also future lapse rates.

A further objection to the calculation and presentation of financial information on two separate bases is one of cost. This is an empirical question on which I am sure evidence could be accumulated during consultation on a proposal to make the sort of changes which I have suggested.

A further area of accounting controversy which has arisen during the current financial crisis relates to the traditional part of bank balance sheets: the loans which they have made to companies, home buyers and credit card holders. Mark-to-market rules do not apply to these assets, which are accounted for at essentially cost less an allowance for credit losses. Accounting standards require that the allowance for credit losses be calculated using the “incurred loss” model. Under the incurred loss model impairment of a loan can only be recognised where there is objective evidence that impairment has occurred. The requirement for objective evidence is designed to reduce the

extent to which bank management can make subjective decisions about the amount of loan loss provisions. If there is a high degree of subjectivity in the assessment of provisions then there is a temptation to “tuck away” higher than required provisions in good years which can be used to cover losses arising in bad years thus disguising the underlying trend of profitability.

Some commentators have described this method of accounting as undesirable because it is “pro-cyclical” and it, therefore, is damaging to financial stability. However, accounting is a measurement mechanism and, therefore, it should not be surprising that banks report large profits in periods of rapid GDP growth and then losses in periods of GDP decline. I would argue that it is a good thing that accounting is reflective of the economic cycle and am unclear at what point one might conclude that one has too much of this good thing.

The ASB recently convened a meeting of stakeholders to review this issue and to consider alternatives to the incurred loss model, such as so-called dynamic provisioning. There was strong support for supplementing the incurred loss model with the Economic Cycle Reserve (ECR) proposal

which was included in the Financial Services Authority's recent Discussion Paper on the regulatory response to the global banking crisis.

The ECR, which is a sophisticated name for a rainy day fund would banks to disclose the amount of additional reserves they have established, in future upturns, to allow for the possibility that not-yet-incurred losses may emerge in future down-turns. The ECR could also be used to address the possibility that not all mark-to-market gains in rising markets may subsequently prove to be convertible into cash.

Overall, I believe that accounting has held up well considering the extreme stresses in the financial system. I do not believe that there is any serious support for the proposition that accounting caused the financial crisis. Nor should there be support for the proposition that we can prevent a recurrence of the problems by changing accounting standards any more than we can solve global warming by changing the scale on thermometers.