Performance reporting and stability

Date: 12 December 2016
Speaker: Hans Hoogervorst, Chairman, International Accounting Standards Board
Venue: 6th Symposium on Accounting Research, Paris, France

Introduction

In this conference on accounting and performance I would like to talk briefly about two important contributions that emanate from the mainstream French accounting tradition.

Let me begin with the French contribution that inspires me. The Cartesian mindset of your country enjoys order. That is why you had the Plan Comptable, which prescribed in detail how preparers should format their financial statements. After the introduction of IFRS Standards, which—to the horror of many French people—created mild chaos in terms of presentation, the French accounting authorities produced recommendations on how various economic sectors should format their financial statements.

The IASB has recently also come to the conclusion that we need more structure in the financial statements. We define revenue and profit or loss, but do not define much in between. As a result, financial statements are not always comparable above the bottom line. Investors need comparable disaggregation to judge the performance of a company. We also need more formatting to adapt to the fact that the vast majority of financial data are now consumed electronically. We need to step in to provide more quality and rigour to the formatting currently done by market participants such as data aggregators.

So I believe the French instinct to provide more structure to the financial statements is sound. While IFRS Standards will never become as detailed as the Plan Comptable, we will draw inspiration from your work.

Fair value

I am more critical of the French accounting tradition’s problematic relationship with fair value accounting. I think it is fair to say that this accounting philosophy reflects the tradition of Colbert, according to which the market should not be guided by an invisible hand, but instead be firmly led from the top.
The policy paper of professor Sandra Rigot neatly sums up the mainstream French position: fair value accounting reflects a belief in the efficient market hypothesis and leads to market-based volatility in the financial statements which discourages long-term investment. In her view, long-term investments should be subject to cost accounting, with value gains only to be recognised when management chooses to sell the equity.

In this light, it is no surprise that our decision to do away with the IAS 39 Available for Sale category for equity investments in IFRS 9 was especially (and almost exclusively) bemoaned in France.

Let me make clear that the assumption that the IASB believes in the efficient market hypothesis is completely mistaken. We are not market fundamentalists. We are pragmatic! The vast majority of our accounting standards are cost-based, and in our Conceptual Framework, we have made it perfectly clear that we do not see fair value accounting as the default mode.

At the same time, I firmly believe that cost-based accounting is inadequate for reflecting the performance of long-term equity investments. Quite the opposite— the longer term an investment, the less relevant its original price becomes. I fail to see how investors would benefit from a balance sheet that shows the original price of an equity investment acquired 20 years ago.

Furthermore, cost accounting for equity investments leads to all sorts of problems. The biggest problem is when to recognise losses. Under IAS 39, many preparers recognise losses very late. We know that many companies only recognise losses on equity investments when they lose 40–50 per cent of their value. That does not reflect the true performance of a company and is certainly not prudent!

Recognising gains only when a company disposes of an asset may look more prudent, but it is not. When a company recognises in 2016 the gain on an asset acquired in 1996, it takes in one go a profit achieved over a period of twenty years. Does that reflect the performance of the company in 2016? Asking the question is answering it.

These opportunities to carefully select loss and profit recognition give companies a huge potential for earnings management that masks the true performance. It is very easy to hide a deteriorating financial performance of a company by selling some old assets. We know that this happens in practice and we do not believe it is prudent.

I recognise that market-based valuations of equity can lead to more short-term volatility in the information reported in financial statements. But we believe that this volatility reflects the risks associated with such investments. Presenting these equities at cost does not make the volatility go away.
Long-term investments

Like many French constituents, I believe it is wise for long-term investors, like insurance companies, to invest in equities. Over the long run, such investments often offer a better return than do government bonds. But such long-term investors need to have adequate capital buffers to withstand the short-term volatility in equity investments.

I do not think there is much point in blaming accounting or prudential requirements for not providing adequate capital buffers. Prudential requirements are just the bare minimum that regulators think is necessary for banks and insurers to operate safely. Nobody stops them from holding higher buffers, which give more room for investments in riskier, but potentially more rewarding, assets.

Long-term investment should not be encouraged by artificial accounting stability in the numbers. Long-term investment is best served by transparency that the public can trust.

I thank you for your attention.