

## IASB Speech

### **Bad accounting breeds bad policies**

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**Speaker:** Hans Hoogervorst, IASB Chairman

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It is a pleasure to be with you here in Edinburgh. Of course, Edinburgh was the home town of Adam Smith, often referred to as the father of modern economics. Adam Smith is best known for *The Wealth of Nations* and its concept of the ‘invisible hand’. In his view, rational self-interest guides market participants to trade in a mutually beneficial manner. However, he also wrote *The Theory of Moral Sentiments*, in which he describes how the act of observing others makes people aware of the morality of their own behaviour.

These concepts are as relevant today as they were in the 18<sup>th</sup> century. I would like to think Adam Smith would have been a big fan of IFRS, because it allows the ‘invisible hand’ to work at an international level. IFRS helps investors to identify opportunities and risks across the world. Capital can be allocated on the most efficient basis, while the friction of national accounting regimes is removed. Adam Smith would probably also have approved of IFRS because it helps investors to observe how others, namely company management, are looking after their resources.

This notion of stewardship is critical to the wellbeing of financial markets, because we live in a world where most people who work in financial services are working with other people’s money. As a result, moral hazard is everywhere, as the financial crisis has amply demonstrated.

The IASB plays a small but important part in keeping this whole system honest. Our role is to develop and maintain a global language of financial reporting that helps to reduce this moral hazard. We do this by closing the information gap between investor and investee. We close that gap by providing reliable and comparable financial information to investors, such as you.

### **Pension accounting**

Let me now turn more specifically to accounting and pensions.

If you want to know how crucial proper accounting for pensions is, just look at an area where it is highly deficient. I am of course referring to the accounting for pensions in the public sector. Indeed,

for many countries, the pension liability of the public sector is not recognised or measured at all. Fortunately there are some countries that do, but even there the pension liability is not always fully consolidated in the public sector balance sheet.

This lack of proper accounting hides from view a very inconvenient truth. In many countries, the public sector pension liability is larger than the debt of the Greek government<sup>1</sup>. But unlike the Greek debt, the pension liability is not (fully) shown. That means no Troikas and no adjustment programmes, so the inevitable restructurings will probably come too late. Bad accounting breeds bad policies.

In the private sector, accounting requirements are much more rigorous. IFRS requires companies to provide up-to-date and comparable information about their pension liability. This is the good news. The bad news, of course, is that the numbers, although much better than in the public sector, are still not very pretty.

According to Mercer, pension deficits at the UK's largest companies have nearly doubled over the past year to record levels.<sup>2</sup> Indeed, some FTSE 100 companies have pension liabilities that are larger than their equity market value.<sup>3</sup> These deficits are driven by a prolonged period of extremely low interest rates. On top of that, people just keep on living longer.

This is all bad news for the companies that are responsible for underwriting these liabilities, but at least investors know about them. Unsurprisingly, research shows that investors are wary of investing in companies with large pension deficits.<sup>4</sup>

So at least IFRS brings the problem out in the open. The question is, do we do it in the right way?

I'm sure that some people here today believe that accounting standards rely too much on fair value measurement, lead to too much market volatility and do not serve your long-term perspective as long-term investors.

I do not agree with this view, but I can understand where it is coming from. Short-termism is rife across the financial markets. Markets can get things very wrong—and for very long periods of time. The efficient-market hypothesis has been rightly discredited. So the long-term investor should not be deterred by short-term market fluctuations and investment fads.

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<sup>1</sup> *'Towards Better Consideration of Pension Liabilities in European Union Countries'*, EDHEC-Risk Institute (2013), [www.edhec-risk.com](http://www.edhec-risk.com)

<sup>2</sup> *'Low interest rates double FTSE 350 DB pension scheme deficits from £56 bn to £107 bn over 2014'*, Mercer (2015), [www.mercer.com](http://www.mercer.com)

<sup>3</sup> *'Sainsbury's £592m pension deficit poses a 'material risk to business''*, Ruddick, The Telegraph, 14 July 2014

<sup>4</sup> *'Corporate Pension Plans as Takeover Deterrents'*, London Business School, Cocco & Volpin (2012), [www.london.edu](http://www.london.edu)

At the same time, any sensible long-term investment strategy will have to evaluate continuously how changes in the market may affect the ability to achieve its goals. As Keynes flippantly said, there is nothing so disastrous as a rational investment policy in an irrational world.

Current market conditions are a good example of this. Extreme monetary policies all started as short-term emergency measures. Japan's Zero Interest Rate Policy was originally put in place 'until deflationary concerns are dispelled'.<sup>5</sup> Now, a full 16 years later, the same short-term policy remains in place and has even become more extreme.

As long as Europe is threatened by huge mountains of public and private debt, unconventional monetary policies are probably here to stay. Most central banks are fully aware that low interest rates are detrimental to the business model of insurance companies and pension funds. But I am afraid they just see it as inevitable collateral damage in the efforts to keep the debt burden manageable. So unconventional might become the new normal.

My point is that it is very hard to distinguish what is a short-term blip from something that is the beginning of a long-term trend. That is why, in accounting, providing current information—and not just historic cost—can be so important.

As accounting standard-setters, we try to strike the right balance. For example, our most recent amendments to IAS 19 *Employee Benefits* removed the so-called 'corridor method' of deferring the recognition of actuarial gains and losses. As a result, the balance sheet pension asset or liability now represents the actual funding position. Investors generally see this as an improvement.

At the same time, we also introduced a requirement that these remeasurements of the net pension asset or liability must be reported within Other Comprehensive Income. This change avoids potentially huge swings in the status of pension funding from dominating the all-important Profit or Loss and Earnings Per Share numbers.

The downside of excluding the pension liability from Profit or Loss, however, is that it might lead to problems festering too long. Should companies really be paying dividends when big pension deficits continue to eat away at their balance sheet? Arguably, the discipline of Profit or Loss would lead to more timely action.

In any case, there is little doubt that the transparency provided by modern accounting standards has helped management to deal with these issues in a more timely fashion. Pension schemes are being transformed in a very rapid fashion. Less than a quarter of FTSE 100 companies now offer defined

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<sup>5</sup> Ito (2005), *'Japanese Monetary Policy: 1998-2005 and Beyond'*, Bank of International Settlements, [www.bis.org](http://www.bis.org)

benefit schemes to a significant number of employees.<sup>6</sup> In their place, many companies in Europe and around the world are moving towards so-called hybrid pension schemes.

These hybrid schemes may be more affordable to companies, but from an accounting perspective they do not fit neatly into the ‘defined contribution’ or the ‘defined benefit’ categories in IAS 19. In fact, modern pension schemes can have infinite variations, from the extremes of defined contribution through to defined benefit, with differing degrees and forms of risk-sharing. The somewhat binary approach of IAS 19 struggles to deal with this new, infinitely variable pension landscape.

That is why the IASB has decided to begin a research project to develop an approach to pension accounting that works for all types of schemes. In doing this, we may be able to draw on the work we have done on insurance accounting. In developing a more general model for pension accounting, it makes sense to consider other issues that have arisen in practice, such as the problems of determining the high quality bond yield.

Of course, it is little more than two years since the revised IAS 19 came into effect. It is important for us to see how those changes bed down before considering whether to make further changes. It will take several years to complete the research and your input will be a crucial factor in determining whether and how to proceed.

## Close

Let me come to a close. I do not need to tell you that the world of pensions faces tremendous challenges. The financial crisis has turned everything upside down. Your business model is under severe pressure from unorthodox monetary policies. To add insult to injury, accounting standards make these pressures visible more quickly than before.

But I firmly believe that you are not served by standards that create fake stability by smoothing out problems over the years. I believe that you, as both investor and manager, are best served by accounting standards that reflect economic reality as accurately and timely as possible. This allows you to nip problems in the bud, rather than allowing them to fester on.

I look forward to a lively panel discussion and I thank you for your time and attention.

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<sup>6</sup> JLT (2015), ‘*Closedown of DB Schemes Accelerates Among FTSE100 Companies*’, [www.jltemployeebenefits.com](http://www.jltemployeebenefits.com)