IDW
INSTITUT DER WIRTSCHAFTSPRÜFER

Conclusions from the Financial Crisis: A View to the Future

The current financial crisis is a global phenomenon. The origins lie in the USA, where an increased number of loan losses have occurred since 2007, particularly in the sub-prime mortgage market. However, structured refinancing has caused the relevant risks to spread worldwide and to also affect German investors, particularly those in the financial sector. In addition, the crash of the investment bank Lehman Brothers in September 2008 caused the crisis, which was initially limited to certain sub-segments of the financial markets, to develop into a general crisis of confidence in global financial markets, and to affect the real economy to a large extent. Therefore, measures to deal with the crisis, where possible, require a consistent approach on an international basis, or, at least, international coordination.

According to most analyses so far, a variety of sectors need improvement to make the financial system more resistant to future crises. This accords with the views of the German Wirtschaftsprüfer profession (German public auditors). The IDW has outlined suggestions for improvements in ten selected areas.

Oversight of financial markets

Ideally, the situation requires a globally responsible central oversight authority. However, an overall global harmonization of financial market oversight is doomed to fail because national legal and economic distinctions cannot be harmonized immediately. In addition, the efforts to develop globally coordinated regulations should not affect the implementation of measures necessary in the short run. However, the intensification of the co-operation between the national oversight bodies is required and feasible. Oversight bodies must be in a position to identify not only the risks for the individual institutions, but also the overall risks for the national economy. International co-operation would also be the basis for developing a global early-warning system.

The IDW supports the efforts to achieve effective, and preferably, transnational regulations for all financial sectors to assure sustainable stability and integrity of financial markets. Compliance with these regulations would need to be monitored continually; loopholes in regulators oversight must be closed. In particular, special purpose entities that are not subject to regulatory oversight should no longer be permitted because they have been used as a vehicle for the outsourcing of business activities that, in principle, otherwise would have been subject to regulatory oversight, to a business sector not subject to regulatory oversight.

For these reasons, risks must be subject to adequate oversight irrespective of whether or not they are (legally) transferred to a special purpose entity. The inclusion of special purpose entities in consolidated financial statements should also be considered by the German Act to Modernise Accounting Law (AMAL). Capital requirements or the inclusion of special purpose entities in consolidated financial statements should only be permitted if the risks are effectively transferred to a third party. In any case, transfers of business activities or risks to special purpose entities could be made subject to approval by oversight authorities.

Transparency and objectivity of credit ratings

Market participants are often not in a position to adequately assess the risks embodied in financial instruments, particularly if the owner of the financial instrument does not have sufficient information, e.g. because of the complexity of the instrument or because of a lack of influence on the issuer. If the instrument has a low trading volume, having owners obtain comprehensive information directly may be uneconomical from the cost and benefit perspective. In this situation, credit rating agencies may effectively support the financial market, particularly investors and oversight bodies, but also auditors.

The financial crisis proves that this role has room for improvement. The development of an appropriate regulatory framework including transparent structures and rating methods needs to be considered. This should be supported by adequate independence requirements to ensure, for example, that credit rating agencies are not involved in the evaluation of financial instruments in the development of which they played a significant role. It is also important to ensure that credit rating agencies do not pursue any financial self-interest in marketing these financial instruments.

In this context, the proposals of the EU Commission to regulate credit rating agencies represent a worthwhile approach. Continual control over compliance and the sanctioning of violations thereof is a crucial element of any internationally agreed control framework for credit rating agencies.

Should the above-mentioned suggestions be implemented, the creation of a European credit rating agency under public law would become less important, particularly as it is not clear how such a newly created credit rating agency could assemble the necessary expertise in the short term.

Government support for the financial industry

Measures drawn up or considered by the governments aimed at strengthening market participants' positions should be supported to the extent such measures are necessary to assure the stability of national economies and to restore confidence in financial markets. It is most important to address systemic risks. In contrast, the non-systemic risks should continue to be borne by the private sector. However, such a solution does not guarantee undistorted competition. How to prevent the building up of systematic risks in advance is, therefore, a subject that needs to be considered in future discussions.

Actions taken by the government should not be of a permanent nature and the negative impact on public finances should be kept as low as possible. If the government takes on private corporate responsibilities, it is important that these responsibilities be returned to the private sector as soon as possible.

The provision of bank credit to the market is important for economic stabilization, particularly in the current situation. A functioning banking sector is paramount for coping with this crisis. Actions to protect banks from possible further imminent crisis-related losses could help to re-establish the confidence in the banking sector and among financial institutions.

The scope and the size of the government stimulus package is a political decision to be taken by the legislator. However, such a decision must sufficiently account for the responsibility of the financial institutions for their transactions and risks. Furthermore, the banks' expertise in risk-management and in the servicing of toxic securities must continue to be available.

There are various instruments to help financial institutions avoid further losses. Possible instruments are , for example, government guarantees for risky assets or the transfer of risky assets to an external entity – subject to adequate terms. The assistance can only be efficient and have a positive effect on balance sheets if the primary risks of a financial instrument are permanently withdrawn from the financial institution and if the primary rewards of the financial instrument are permanently transferred to a third party.

It seems appropriate that these supported financial institutions should, in return, pay reasonable compensation to the public for the financial support they received, once they have rebound from the crisis, given the fact that the risks were caused by their business policies. An income bond in favor of the public funds could be an option. The income bond would be financed by a bank's future profits. Conversely, if the realization of the transferred financial instruments

leads to a profit, once the crisis is over (and taking into account the attributable costs), the bank can be compensated accordingly.

Close monitoring of management by the supervisory board

The crisis shows the need for adequate control of management by active and competent members of the supervisory board. It also raises the question whether the authority of the managing board to engage in risky transactions should be more restricted - primarily in relation to those risks that have the potential to jeopardize the company's ability to continue as going concern. Even if such latent risks seem unlikely, they need to be adequately reported to, and considered by, the supervisory board. Therefore, it should be stipulated that those transactions carried out by the executive board that bear potential risks to the ability of the company to continue as a going concern must be subject to the supervisory board's approval or to an explicit authorization in the articles of association. In addition, the company's system of risk identification and responses to risk must assure that all major risks, irrespective of their probability of occurrence, are identified, analyzed, communicated and are dealt with appropriately.

Closer co-operation between the supervisory board and the public auditor

A close co-operation between the company's supervisory board and the public auditor is crucial to good corporate governance. Continual communication is a precondition for the ability of both auditor and supervisory board to perform their tasks satisfactorily. The German Code of Corporate Governance should require the supervisory board to communicate with the auditor on the development of the business and the associated risks. It should be discussed in more detail how, also with the help of the auditor, the supervisory board can be better informed about those transactions that may have an impact on the company's ability to continue as a going concern.

Effective financial incentives

Furthermore, the supervisory board is responsible for determining the remuneration of the company's management. The crisis has revealed that improper financial incentives for management were reasons for the high risks that were taken and thus the current crisis. In particular, the proportion of fixed and variable compensation should be reconsidered. In addition, the variable pay should be tied to the sustainable development of the company – e.g. based on a longer period of time.

Experiences with different structures of corporate governance (a single board system with executive and non-executive members or a two-board system with separate executive and supervisory boards) during the crisis have not shown either system to be superior to the other. If the independence of the non-executive members can be assured in a single board system, on the one hand, and if the supervisory board actively controls the executive board in a two-board system, on the other hand, both systems can be regarded as similarly effective.

Departures from the fair-value measurement of financial instruments

The financial crisis has also revealed a number of deficiencies in the field of financial accounting, which should be corrected by amending the relevant accounting requirements. The focus in this respect is on the rules for accounting for financial instruments.

A measurement of financial instruments based on their fair values does not always reflect the actual rewards and risks to which a company is exposed, for example, when a company holds fixed-interest securities to maturity, short-term market fluctuations remain without effect on the actual financial position and performance. Partly, the IASB has taken these arguments into account, which is shown by the most recent amendments to IAS 39, which permit reclassifications of financial instruments out of the category “held for trading” into the categories “held to maturity” or “loans and receivables” and thereby a transition from fair value-based to historical cost-based measurement under certain circumstances. In view of the IDW, a further expansion of the possibility of reclassification should be considered for those financial instruments that have initially been classified as “at fair value through profit and loss” under the so-called fair value option.

Should the German Act to Modernise Accounting Law (AMAL) require financial instruments that are held for trading to be measured at fair value, it must be assured that these instruments can be reclassified when the intention of short-term selling or repurchasing the instrument ceases to exist. The IDW supports the respective efforts made be the Federal Government to establish such a rule in the German Commercial Code, as least as far as financial reporting by banks is concerned. The current government draft proposes that banks measure financial instruments held for trading at fair value less a value-at-risk deduction. This approach is a confirmation of long established industry practice that has gained general acceptance. The current financial crisis does not provide indications that would require a revision of this assessment or a departure of external reporting from being based on the banks’ internal risk management.

Measurement of liabilities at fair value has proven to be particularly difficult. The worsening earning prospects and the deterioration of a company's creditworthiness result in a decrease in the liabilities' book value and thus in a profit. Therefore, the suitability of the financial statements to provide a basis for forecasts on the future economic situation is considerably impaired. Action must be taken by the IASB to eliminate such incomprehensible or even misleading effects.

With regard to the accounting principles of the German Commercial Code, consolidation of special purpose entities is an area that should be addressed urgently. So far the German Commercial Code does not require the consolidation of special purpose entities. The German legislator should strive for a harmonization with IAS 27 and SIC-12, which require consolidation, in particular if the majority of rewards and risks of the special purpose entity remains with the company.

Consistency and credibility of amended accounting standards

Amendments to the accounting rules should not provide for opportunities to conceal losses or risks that, in fact, exist. This would lead to a loss of confidence in reported financial information.

For this reason, a temporary suspension of specific IFRS provisions that have been discussed for some months should be rejected. In principle, all adjustments to accounting rules should be strictly within the competence of the IASB and should be subject to appropriate consultations. Isolated decisions at European or national level are detrimental to international and interdependent capital markets and should only be considered if the IASB rejects compelling proposals for amendments or does not react timely.

Proposals to increase the accumulation of reserves should be pursued. However, any intransparent aggregation (and later disaggregation) of secret reserves based on the management's judgment is inconsistent with a financial accounting paradigm that aims at providing investors with useful information for decision-making. Rather, the creation of such equity cushions should be part of the allocation of profits to appropriated retained earnings. Such a building-up of reserves could be mandated by respective regulatory requirements.

Accompanying the IASB's standard setting activities

The course of the crisis has shown that short-term adjustments to accounting standards are not an issue of a mere technical nature; political and strategic considerations must also be taken into account. For this reason, a high-ranking expert commission on a national level should be formed, e.g. at the German

Federal Ministry of Justice to accompany the IASB's standard setting activities from a political perspective.

Such a committee should also discuss essential issues relating to the future direction of financial reporting. The 2008 annual report of the Financial Reporting Enforcement Panel (FREP) indicates that the IFRS are far too complex which leads to them being prone to a high rate of misstatement. The IDW supports FREP's request for simplification, particularly in areas where today's rules do not improve the decision usefulness of financial statements.

In addition, the reliability of financial reporting could be increased if users and preparers would not be confronted with such frequent and often comprehensive changes in the accounting framework. Moreover, to ensure proper implementation of new or amended standards, the standard setting process must include a careful analysis of the practicability of rules and their implementation cost.

Risk awareness in relation to the information in financial statements

The financial crisis does not only affect the financial sector and manifests itself not only in losses in value or a limited fungibility of financial instruments. In fact, the concurrent economic slump creates a difficult economic environment for companies in all sectors. This may be reflected in the assessment of the recoverability of goodwill or the unavailable use of deferred tax benefits, particularly those resulting from a tax-loss carryforwards. Declining sales or the drawing on credit lines granted to third parties might have an even more severe impact on the financial statements. A lack of access to sources of refinancing and a possible worsening of cash position, which could even result in insolvency, are risks that must be also kept in mind.

Given the tense economic situation, preparers and auditors bear a particular responsibility. In the interests of users of financial statements, preparers and auditors must pay special attention to existing risks being clearly and appropriately reported in the financial statements, in particular in the management's discussion and analysis. Under such circumstances a thorough discussion between the management and the auditor. A presentation that could lead to a precarious situation by overemphasizing the risks that are not imminent should also be avoided.

Auditors must be prepared to carry out audit procedures that are appropriate under the specific circumstances and that contribute to strengthening public confidence in sound financial reporting. However, it is up to the stakeholders themselves to obtain an adequate understanding of a company's economic situation by carefully reading and analyzing the financial statements and the

management report. This holds true in particular for the members of the supervisory board. In the auditor's report, the auditor only expresses an opinion whether the financial statements and the management report have been prepared in accordance with the applicable accounting framework; however, the auditor does not certify the financial strength or the stability of the company. Therefore, an unqualified audit opinion should not be understood as a confirmation of a company's economic health.

The possibilities and responsibilities of the management and the auditor regarding the presentation of the company's economic situation and its future development are based upon the knowledge that is available at the point in time when the financial statements are prepared and are limited accordingly. The financial crisis has led to a significant increase in uncertainty about the future economic development of a company. Thus, market conditions existing at the balance sheet date or at the date of preparation of financial statements respectively can change in an unpredictable manner. As a consequence, neither management nor the auditor might be able to reliably forecast a further deterioration of the company's economic situation, including the possible loss of the company's ability to continue as a going concern.

In addition, increased volatility generally makes forecasts much more difficult compared to periods of economic stability. Therefore, stakeholders should not use only historical financial statements, but also additional current information in order to get an accurate and up-to-date picture of the company's development and situation.