

Presentation of an International Accounting Standard (International Financial Reporting Standard) (IFRS), 8-9 April 2003. (Joint KPMG and BNA initiative)

The Economist, August 17-23, 2002: “ *I swear..... that, to the best of my knowledge (which is pretty poor and may be revised in future) my company’s accounts are (more or less) accurate. I have checked this with my auditors and directors (whom I pay) and they agree with me....”*

1. Introduction.

Financial reporting in general has gained more (inter)national attention in recent months after the bookkeeping scandals of Enron, WorldCom, TYCO, Xerox, KPN Quest, and AHOLD. In a sense, this increased attention has helped all stakeholders -- be they employees, creditors, shareholders, government, board of directors, or audit firms -- to become more interested in the real value of businesses. What is, or what might be the mysteries behind the figures presented in financial reports?

Financial reporting and particularly the annual reports of companies play an important role in achieving adequate corporate governance here and around the world. In recent years, the Bank has been at the forefront in promoting the implementation of sound Corporate Governance principles within the financial sector. We continue to emphasize to the managing and supervisory board members their responsibility to fully and adequately enforce the guidelines on Corporate Governance in general, and in particular, to provide more transparency through adequate information and financial reports.

Through financial reporting, the managing and supervisory board members of companies provide their shareholders and other stakeholders with the past results of the business being managed and supervised. These reports give more in-depth insight into the income statement and balance sheet, and they, therefore, help the users of these reports better understand and assess the financial performance of the business. In general terms, accountants tend to view financial reporting more retrospectively, while supervisors have to balance past performance with their perspective on the future of the institutions. It also is important to know that all stakeholders base their (investment) decisions mainly on the financial reports, thus reinforcing the importance of providing adequate and accurate information. Therefore, financial reports are a crucial management tool while at the

same time, providing the board with an opportunity to explain to stakeholders the institution's performance and achievements during a reporting period.

Since the bankruptcy of Enron, the accounting regime worldwide is being reformed rapidly to ensure that company accounts are more reliable and that they keep abreast of generally accepted accounting standards. In the United States, this reform effort led to the Sarbanes-Oxley Act, which in essence prohibits audit firms from undertaking non-audit work (consultancy services) for their audit clients, thereby limiting possible conflict of interest of the auditors and enhancing their independence. In our view, this is a very good first step in assuring stakeholders that the audited financial reports are useful and reliable instruments for assessing the financial health and the performance of companies, and we welcome this step.

A publication of 'Bank en Effectenbedrijf' (November 2002)¹ contains an interesting article on why the informational value of financial reports became more tainted by external circumstances and, most specifically, what propelled company scandals in the United States.

One of the first factors that affected the financial reporting of companies was the collapse of the stock markets after years of extraordinary growth due to 'speculative' investments in internet companies and in the telecom sector. Investment portfolios and business results linked to performance in these sectors in the four years preceding 2000 grew without apparent limit until the market sentiments turned against these sector-specific investments during 2000. After three years of commotion in the markets, we witness many cases today where not only institutional investors but also many individuals have seen their portfolio value reduced to only a fraction of what it was worth during the 'good days'. This loss of portfolio value had to be compensated one way or the other and this led to certain notorious cases of 'creative accounting'.

A second reason for corporate scandals is that many senior company officials in recent years have made a greater part of their remuneration dependent upon the outcome of the company's share-value through straightforward option bonuses. Under these circumstances, senior managing board members have a greater than normal personal interest in better short term performances of the (stocks of) institutions being managed, even if this means that the underlying information is incorrectly presented in the financial reports. In fact, since the remuneration of senior

¹ "Het belang van internationale verslaggevingstandaarden"; Prof. Dr. M. Hoogendoorn.

management depends largely on the company's performance, management is more inclined to put aside accounting standards to reap the fruits from misleading information/reports.

Both factors contributed greatly to the scandals we have seen in recent years. Therefore, both the option bonuses and the over-concentration of investments in certain sectors or companies should be limited through supervisory guidelines. We will elaborate on that later.

2. How will an International Accounting Standard impact the supervisory role of the Central Bank?

Before turning to the IFRS topics in detail, I would like to draw a closer link between the IFRS and the new Basel Committee approach toward banking supervision. The Basel Committee's Capital Accord review has great similarities with the initiatives of the IASB being undertaken from a more audit/accounting perspective. The supervision of the banking sector has undergone widespread changes in recent decades. The Basel Committee on Banking Supervision has been actively involved in promoting sound banking practices throughout the world. The attention of the Basel Committee has been focused on the creation of a set of rules and supervisory standards governing the capital adequacy of major internationally active banks. This work led to the introduction in 1988 of the Basel Capital Accord. This Accord was focused mainly on two fundamental objectives:

- The framework would strengthen the soundness and stability of the international banking system; and
- The framework would be fair and highly consistent in its application to the banks in different countries to create a level playing field among internationally active banks.

Despite the effectiveness and the success of the Capital Accord since 1988, the Basel Committee on Banking Supervision circulated a proposal for a New Basel Accord. The New Accord will introduce a more risk-sensitive and flexible framework than the Old Accord. While the Old Accord focused on a single risk measure, the New Accord puts more emphasis on the banks' own internal methodologies, supervisory review, and market discipline. The New Basel Accord is based on three mutually reinforcing pillars that allow banks and supervisors to evaluate properly the various risks that banks face. All of the reinforcing pillars will contribute to safety and soundness in the financial system. The first pillar deals with minimum capital requirements, which seek to refine the measurement framework set out in the 1988 Accord. The second pillar is that of the supervisory review of the institution's capital adequacy and internal risk assessment process. And the third pillar deals with market discipline through effective disclosure to

encourage safe and sound banking practices. This disclosure pillar is closely related to what the IFRS does with regard to IAS 30.

The starting point for banking supervisors performing on-site examinations at supervised institutions is the financial reports. Furthermore, the auditor's opinions, and the management letter are instrumental for supervisors when assessing the performance of institutions under supervision.

Three major guidelines of the IAS that will impact financial reporting and in particular, the banking sector are IAS 30, 32, and 39. In general terms, these standards are largely in line with the New Basel Accord principles being discussed.

The IAS 30 standard, which deals with disclosure issues, is comparable to the third pillar of BIS's New Capital Accord proposals. This third pillar (market discipline) aims to encourage market discipline through enhanced disclosure at the institution level. The Basel Committee is convinced that effective disclosure is essential to ensure that market participants can better understand a bank's risk profile and the adequacy of the bank's capital position. The New Capital Accord is scheduled for introduction by 2006.

The IAS 32 standard on Financial Instruments; Disclosure and Presentation sets a minimum guideline for disclosure and presentation of asset and liability for financial reporting. This is an important tool of information for the user of financial reporting, e.g., the supervisor.

The IAS 39 standard, which deals with the recognition and measurement of financial instruments, can be considered a real and major revolution for the valuation of assets and liabilities in financial institutions. It is perceived now that the IAS 39 will have a major impact on the operation and reporting of financial institutions as was illustrated with the presentation of KPMG. The IAS 39 departs from a mixed valuation model. Dependent upon the choices of the financial instruments or the type of the balance sheet item, the asset or liability will be valued either at cost or at real (fair) value. Discussion on this mixed-model of valuation has not been decisively concluded. It is now clear that, in practice, almost all investments will have to be considered in the financial reports of institutions at real (fair) value. However, it is clear that most financial instruments should be valued at 'fair value'. These are:

- all financial instruments kept in the financial institution for trading purposes;

- all derivatives;
- all financial assets readily available for sale.

Using real or fair value will result in more volatility in profit and loss accounts and the equity and the solvency of the institutions. This volatility is of great concern to supervisors. Increasing the overall minimum solvency ratio in the New Basel Accord from the current 8% is not intended for the banking sector as a whole. Supervisors may consider using a higher minimum solvency ratio especially to deal with the higher volatility resulting from the implementation of the IAS 39. This issue has not been resolved internationally. The Bank long ago took the position that the banks under our supervision should have a minimum solvency ratio above the 8%, especially because of the higher perceived risks in smaller economies/jurisdictions like the Netherlands Antilles. Therefore, we will have to review this aspect further.

Another important issue in this respect is how to treat expected losses in the loan portfolios of banks. The idea is to determine the loan loss provision on the basis of the present value of the expected future cash flows of loans. The solvency requirements for expected losses in the loan portfolio should then be directly linked to the loan(s) being investigated. The bank's capital position will identify and disclose only the unexpected losses in loan portfolios. Here again both Basel Committee proposals and the IAS 39 coincide. In essence, the capital of financial institutions is there to absorb the unexpected losses. This line of reasoning in the IAS 39 is completely in line with our own guidelines and practices.

If we now turn to the possible implications of the IAS for pension funds and insurance companies, we can single out two relevant IAS standards that will directly apply to the financial reporting of these institutions: IAS 19 and IAS 26. The IAS 19 handles Employee Benefits, and IAS 26 deals with the Accounting and Reporting of Retirement Benefit Plans.

With regard to the IAS 19, we have seen in the presentations of the KPMG that in the *defined contribution pension plan*, almost the entire risk with respect to the difference between the fair value of the pension fund investments and the present value of the pension obligation remains with the employee. Therefore, no additional risk-control measures and reporting obligations outside the pension plan financials are required. The changes proposed in the IAS 19 will have only a marginal influence on the presentation and disclosure issues related to the above-mentioned difference.

On the other hand, if the pension plan is a *defined benefit scheme*, the case becomes complicated since the differences between the present value of the pension obligation and the fair value of the financial assets will have to be presented as an asset or an obligation in the balance sheet of the employer that offers the pension plan. Currently, pension funds have difficulties both internationally and domestically guaranteeing a solid financial position due to the negative developments in the international stock markets where some pension funds have traditionally invested. In the cases of a possible underfunding of the pension scheme, the supervisors will have to take into consideration the current and future prospects of the employer when assessing the solvency of the pension funds. International studies already indicate that the IAS 19 will imply that many employers will have to bear the higher cost of underfunding through their company's accounts. The supervisors in turn will have to assess not only the financial reports and strengths of the pension fund itself, but also the performance and financials of the employer(s) to which the fund is directly linked. We foresee great difficulty in this area since the supervisors also will have to rely on financial reports of the companies to assess the risks involved. An important reason in the past for incorporating a pension fund as a separate legal entity was in essence because of the desire to separate the pension commitments from the employer's business operation.

Note also that unpaid "backservice" obligations will have to be put on the balance sheet of the pension legal entity and this can also result in substantial one-time losses and solvency difficulties.

The developments within the insurance sector are also more complicated due to the nature of the products and services they offer to the public. Of crucial importance in the financial reporting of the insurance sector is that over time, the sector, together with its supervisors, developed their own set of reporting rules and disclosure agreements. In our own jurisdiction, we have during the last two years released various versions of the ARAS (Annual Reporting Automated System) reporting scheme.

Three of the major complicating matters in the area of the (life) insurance industry are that most of their obligations and their investments are long term as a result of the typical contractual obligations in the insurance industry. Under these circumstances, the future expected results of each contract will have to be spread over more reporting years. The calculation of the results over a longer period of time is based on various assumptions used at the time of entering into a new insurance contract. The first complication is that deviations between the actual results and the

results on the basis of the assumptions should be reported in the income statements in the reporting year that the situation occurs. Unexpected results in future (longer term) contracts are not taken into consideration because these are not foreseeable losses that have a high probability of materializing. In these situations, the differences in the valuation of assets and obligations of the insurance sector can have a sizeable impact on the financial results in the year these gains or losses are expected.

A second more specific problem area represents the discounted interest rate (rekenrente) the insurance sector uses to calculate the premiums when determining the present value of future cash flows of insurance obligations. When determining the provision for insurance obligations, the interest rate used to calculate the premiums rate is often used. If the actual investment return (market interest rates) is higher than this premium interest rate in a particular set of insurance contracts, then the customer with a profit-sharing plan insurance contract will benefit. The situation becomes more cumbersome and complicated if the investment return fall below the interest rates used to calculate the premium as is the case currently in some areas. Here again the supervisors should quickly anticipate the possible consequences that this situation poses for the entire insurance industry and amend the discounted interest rate used to calculate the premium. Under this scenario, any possible losses in the valuation differences in assets and contractual obligations that proceed from this will have to be booked first from the insurance provisions. The differences in realized losses will be taken up only into the income statements of the institutions in the respective reporting year that this takes place and as long as the provision is not used up. This is the current 'modus-operandi'.

A third relevant scenario is comparable to the situation we are experiencing today with unfavorable developments in stock markets around the world, which have negatively impacted the portfolio value of investments in the insurance industry. How has the sector dealt with this situation? In part, some companies have taken up the lower valuation of the investments in the profit and loss statements while booking another part from the equity (past provision for asset revaluations). We don't know whether the current depressed situation in the stock markets will prevail and for how long. A prolonged depressed stock market is particularly difficult for the insurance industry since its financial results are largely dependent on the outcome of investments.

With the introduction of IAS and then again in particular the fair value of assets in IAS 39, this situation of volatility in the results and the solvency will have to be studied further. The same

scenario described above on the implication of the IAS 39 for banking institutions holds here. The volatility of the results due to the reporting of investments based on 'fair' value may lead to huge fluctuations in the net results and may have serious negative effects for the solvency of the institutions under supervision. Again, as supervisors of the institutional investors sector, we might have to reconsider our minimum solvency requirements to capture the foreseeable fluctuations in this position of the sector.

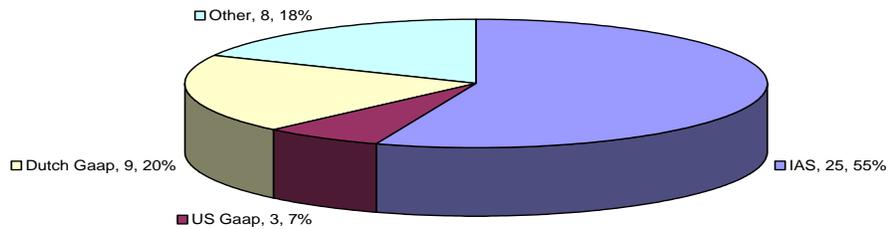
3. The view of the Central Bank on the introduction of the IAS.

The Bank van de Nederlandse Antillen is currently working on the introduction of a mandatory regime of accounting principles for the institutions under its supervision. In the coming months, our staff will be preparing the final framework for the guidelines on accounting principles. The proposed guidelines ultimately will be highly dependent on international developments in this field. Here I especially think of the preparatory work being undertaken by the Basel Committee (BIS) and the International Association of Insurance Supervisors (IAIS) on adequate and well-structured financial reporting systems. In addition, we will have to look to more practical solutions for some specialized institutions and secondary institutions here with regard to their reporting and use of accounting principles.

The Bank supports completely both the efforts of the BIS and the IAIS aimed at creating better and clearly defined disclosure mechanisms for financial institutions. The Bank considers it extremely important for financial institutions to use sound accounting principles in their reporting. Furthermore, adequate disclosure guidelines also are a very important aspect in improving transparency in the markets. Both will be of interest not only to the supervisors, but they also will enhance the information available to the investor, the depositors, and the policy and account holders of financial institutions. According to the Bank, and here again our view is consistent with the international supervisory community, high quality financial statements that adhere to accepted international accounting standards in reporting are essential tools for providing the transparency and facilitating the process of market discipline in the financial market.

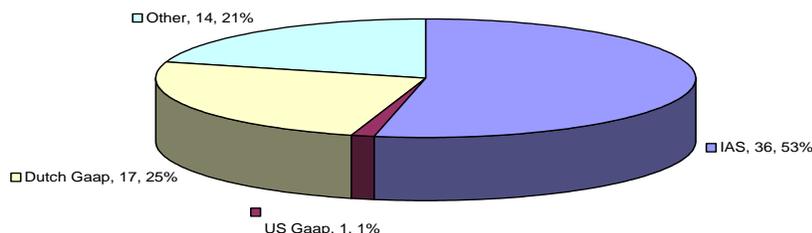
Disclosure creates more transparency. In view of the importance of this subject for the Bank, our supervisory staff will continue to work on a system of disclosures designed for the institutions under its supervision. A recent study by our staff on the use and implementation of accounting standards revealed the following results:

Accounting principle Banking Institutions



These results show clearly that IAS is used widely by banking institutions in the Netherlands Antilles. Some 55% of the banking institutions here already use IAS. According to the European agreements, the approximately 7000 companies listed on the stock exchanges today will have to switch to IAS by 2005. After this amendment of principles, almost 75% of the banks here will be using IAS. Therefore, the Bank will consider strongly whether it is prudent to introduce only one set of accounting standards for all institutions here or whether a limited number of standards will be accepted. In doing this, the Bank will consider a number of factors including the size of the institutions, the type of business being conducted by the institutions, the interest of the respective stakeholders (US customer or European customer base) and the importance of the institutions within our market.

Accounting principle Institutional Investors



Among the institutional investors, the use of IFRS (IAS) here is comparable to the results in the banking sector. Here 53% of the institutional investors currently are using IAS; after amendments of the Dutch GAAP in 2005, the percentage will rise to 78%. So for both sectors, one can conclude safely that by 2005, three out of four institutions in the Netherlands Antilles will be using IAS.

Comparability of financial reporting among institutions of the same type is crucially important to the Bank. The Bank considers it important that those institutions belonging to the same segment adhere to the same standards. In principle, we will require these institutions to adhere to the same generally accepted accounting principles. However, the Bank will carefully examine each situation and come up with guidelines. In this regard, we will appreciate the opinion and suggestions of you as stakeholders.

The Bank currently is evaluating the following proposal:

For credit and banking institutions:

Domestic banks	IAS
International banks	IAS and possibly another GAAP
Credit Unions	A domestic GAAP, such as the current Dutch GAAP

For institutional investors:

Insurance companies	IAS
Pension Funds	IAS and/or a national GAAP, such as the current Dutch GAAP
Investment Companies	IAS or US GAAP

The establishment of one standard, the IAS, or a limited number of standards (probably two other standards) for the preparation of financial statements will receive high priority by the Bank in view of the international requirements and developments. In this respect, narrowing the areas of differences in accounting and reporting concepts and enhancing the value of the financial reports for the stakeholders are essential for the Bank. The Bank also will address the publication aspect of financial statements during this project. The primary starting point will be adequate disclosure by the supervised institutions.

To conclude the discussion of this important topic of accounting standards, we are convinced that clearly defined sets of rules and the consistent use of generally accepted accounting principles will in the long run benefit all stakeholders. Your input in this respect is very important and will be highly appreciated by the Bank.

Concluding remarks.

Some weeks ago we read some disturbing news in the Dutch newspaper quoting the chairman of the board of a well-known international audit firm. He stated that audit firms should strongly consider the alternative of not auditing financials of companies and institutions anymore because of the real threats of becoming accountable and liable for mistakes or for issuing a non-qualified opinion on a financial statement containing misleading information. The newspaper article went on to state that the liability insurance for malpractice in audit firms has more than doubled in recent years due to accounting scandals around the world. This statement was very worrisome and in a sense disappointing; it's like saying that the medical doctor won't operate on a patient anymore because of the fear of being sued for malpractice.

I prefer the idea launched on May 8 last year in a speech of Prof. A Schilder² at the opening of the new Bank building here. He proposed an independent body to supervise audit firms. In this presentation Prof. Schilder said, “Another important issue is the public regulation and oversight. It is all right to make maximum use of sound self-regulation. But the auditing profession should realize that self-regulation alone does not suffice. Like for example financial services, accounting and auditing services are of great importance to society.....strong independent oversight has to be established. It is important not to compromise but to make such oversight independent and powerful.’’

As we have indicated today, the Bank will follow very closely the developments within the IAIS and Basel Committee when amending or introducing new guidelines in the area of reporting and disclosure of financial information. The driving force in the supervisory community during the last two decades was guided through new supervisory techniques and best practice guidelines emanating from the international advisory and financial bodies.

Together with the professionals in the field, our staff in the banking, insurance, and pension supervision departments, together with the local audit and accounting representative organization, will continue to strive for a sound financial industry.

I thank you very much for your attention.

² “Corporate Governance, Accounting and Auditing: Post-Enron issues.” By Prof. dr. A. Schilder RA.