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# APEC Policy Dialogue on Financial Disclosure – Policy conclusions

## 1 Introduction

In February 2004, the APEC Finance Ministers' process held a Policy Dialogue on Financial Disclosure in Kuala Lumpur, Malaysia. The Policy Dialogue was co-chaired by Chile (the Ministry of Finance) and New Zealand (the Reserve Bank of New Zealand) and hosted by Bank Negara Malaysia. Its purpose was to provide a forum for exchanging views on the importance of high quality financial disclosure in the corporate and financial sectors and the means by which such disclosure can be promoted.

This article is a reproduction of the Policy Conclusions paper to be issued under the APEC Finance Ministers' process, summarising the main policy conclusions to emerge from the Policy Dialogue.

The views expressed in Policy Conclusions paper represent a consensual set of conclusions agreed by participants in the Policy Dialogue on Financial Disclosure. The paper does not necessarily represent the views of APEC finance ministers or governments, or those of the Reserve Bank of New Zealand.

The paper has the following structure:

- Section 2 summarises the reasons why high quality financial disclosure in the corporate and financial sectors of the economy is so important.
- Section 3 outlines the foundations for effective financial disclosure in the corporate and financial sectors. These are elaborated on in the remaining sections of the paper.
- Section 4 discusses the role of accounting standards and practices in underpinning effective financial disclosure.
- Section 5 discusses the role played by auditing standards and practices.
- Section 6 discusses the role played by corporate governance in promoting sound disclosure practices.
- Section 7 notes the importance of market-based incentives for high quality financial disclosure.

- Section 8 discusses the means by which investors, financial analysts, depositors and the news media can be encouraged to make more use of financial disclosures.
- Section 9 highlights some specific disclosure issues relevant to the financial sector of the economy.

## 2 Importance of financial disclosure

High quality financial disclosure is essential to the health of the corporate and financial sectors of a modern economy. Disclosure performs a number of important functions. Among them, it:

- **Encourages sound corporate governance and risk management.** Disclosure strengthens the incentives for corporate entities and financial institutions to establish and maintain sound corporate governance and risk management practices. It provides a mechanism by which the directors and senior management team are held to account for the sound stewardship of the company, and the means by which shareholders and creditors, and other stakeholders, can scrutinise the performance of the directors and senior management team.
- **Reduces information asymmetry.** Disclosure reduces the information asymmetry between the managers of a corporate entity and the investors and creditors of that entity, and thereby assists investors and creditors better to assess whether managers are acting in the interests of the company (and thereby in the interests of investors and creditors).
- **Facilitates supervision and reduces monitoring costs.** In countries with constrained resources for financial sector supervision, public disclosure by financial institutions facilitates market-based supervision of financial institutions and shares the cost of monitoring.

- **Facilitates sound investment decisions and resource allocation.** Disclosure helps to encourage better investment decisions by investors and creditors, enabling them to assess the risk/return trade-offs of particular investment opportunities and to identify risk-adjusted rates of return better. In the process, disclosure facilitates improved resource allocation across the economy, and thereby improves the potential growth rate of the economy.
- **Promotes a more robust financial system.** Disclosure can help to promote and maintain a sound financial system by strengthening the incentives for sound risk management within financial institutions and by improving the information which financial institutions use to make credit allocation decisions to the corporate sector. Regular disclosures made by financial institutions enable shareholders/investors, depositors and other creditors to make better informed decisions as to where to place their funds, thereby strengthening the market disciplines on the directors and managers of financial institutions to maintain sound risk management practices.

### 3 Foundations for effective disclosure

For financial disclosure to be effective, and to have maximum benefit for the corporate and financial sectors and for the wider economy, a number of foundations must be in place. In summary, these foundations include:

- Robust and credible accounting standards, which provide for meaningful recognition, measurement and disclosure of information by corporate entities and financial institutions.
- A willingness by government authorities to adopt high quality standards for their own financial reporting, based on best international standards and practice.
- Sound accounting practices, supported by a culture of fair, accurate and timely disclosure and ethical business practices. Accounting standards will be of only limited

effectiveness if not supported by sound accounting practices and business ethics.

- Robust and credible auditing standards and practices, supported by a culture of professionalism and ethical behaviour in the auditing profession.
- Effective monitoring and enforcement of accounting and auditing standards by bodies that have the authority, resources, independence and credibility to perform these functions effectively.
- Sound corporate governance practices play an important role in underpinning effective financial disclosure. In particular, there is a need for companies' management and directors to be legally responsible for the completeness and accuracy of their companies' financial statements and for directors and managers to maintain robust financial reporting systems and internal controls.
- Strong market-based incentives help to promote high quality disclosure. In particular, this suggests the need to ensure that company stakeholders (including shareholders and creditors) are not insulated by government from the consequences of their investment and lending decisions – being exposed to the risk of loss creates the incentives for stakeholders to monitor companies (including financial institutions).
- Structures and practices that encourage and assist the users of financial information to make greater use of financial disclosures, so that there is a strong demand for high quality and timely information.
- The legal framework underpinning corporate disclosure requirements should be flexible so that disclosure requirements can be adapted to changing circumstances without requiring new legislation.

Building the foundations for effective disclosure is an evolutionary process. Careful attention to the sequencing of reforms is required, including the linkages to other relevant reforms, such as in corporate governance requirements, commercial and securities law, contract law, and the design of the financial sector regulatory framework. The requirements for effective disclosure need to be assessed in

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the context of these other elements, so that they integrate in a complementary manner.

It also needs to be remembered that the disclosure arrangements will vary from country to country, depending on the nature of their stage of economic development, and the size and nature of their economy and commercial sectors and legal frameworks, among other matters. A “one size fits all” approach should be avoided.

The foundations for effective disclosure, as outlined above, are discussed in greater detail in the remaining sections of this paper.

## 4 Accounting standards and practice

Accounting standards form the basis of an effective disclosure regime. They set out the frameworks for the recognition, measurement and disclosure of financial information. A system of robust and credible accounting standards requires a number of features, including the following:

- The standard-setting body needs to be well resourced, independent of conflicts of interest and capture by particular interests, and subject to robust and credible accountability and transparency arrangements.
- The standard-setting process should involve input from a wide range of relevant bodies, including user groups, financial statement issuers, accountants, economists, and financial analysts. Standard-setting should be conducted in an open and accountable manner, with all relevant interest groups being consulted.
- Accounting standards should be underpinned by a sound understanding of the needs of financial statement users and issuers, and of the needs of other stakeholders. Standard-setting should not be dominated by financial statement issuers.
- Accounting standards should reflect economic substance to the extent practicable, providing users with economically reliable and meaningful ways to monitor a corporate entity’s financial position, performance and risks.
- International financial reporting standards issued by the International Accounting Standards Board (IASB) provide an important base for national accounting standards. It is desirable that national accounting standards are compatible with corresponding international financial reporting standards, but with the scope to go beyond international standards, particularly in relation to disclosure requirements (rather than in respect of the accounting rules for measurement or recognition of assets and liabilities).
- For international accounting standards to have wide acceptability, it would be desirable for the IASB to be a truly international body, with representation from a wide range of national accounting bodies across all regions in the world. International standards should be subject to thorough international consultation before promulgation, and the standard-setting process should be transparent and accountable.
- International accounting standards are of greater value where they are supported by standardised guidance on their interpretation.
- In designing international and national accounting standards, the IASB and national standard-setting bodies need to have regard to the compliance burdens associated with standards and with the potential for standards to have unintended consequences for economic behaviour. Standards should be designed to avoid excessive compliance costs and distortions to economic behaviour.
- In designing international and national accounting standards, there needs to be a recognition that excessively detailed accounting standards can result in information overload, such that users are impeded in their ability to identify and understand important information about a corporate entity. Striking a sensible balance between the comprehensive disclosure of information and the presentation of key information in a clear and digestible form is essential.
- For accounting standards to be most useful, they must be supported by effective enforcement arrangements, including an independent, well-resourced and

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accountable body responsible for monitoring compliance with accounting standards and taking actions in cases of non-compliance. A strong legal foundation is required for the enforcement of accounting standards.

- Accounting standards will only be effective if supported by sound accounting practices in the corporate and financial sectors. This requires a well-resourced professional accounting body dedicated to promoting sound and ethical accounting practice and high professional standards. It also requires high educational and ethical entry standards for the profession, and a reliable and credible system for disciplining breaches of these standards.
- High quality accounting practices require a corporate culture based on ethical behaviour and a strong belief in and commitment to accurate, fair, regular and timely financial disclosure. This can be fostered in a number of ways, including through corporate governance codes, enforced legal requirements relating to director responsibility for ensuring robust financial statements, and strong ethical leadership by government and business leaders.
- Sound accounting practices are also fostered through high standards of education in the accounting profession at all stages in the career cycle, including setting high entry standards for the profession and arrangements for continuing professional development. Accounting education should not be confined to the teaching of accounting concepts and standards, but should also include the teaching of professional ethics, the economic substance underlying financial disclosures and the informational needs of the users of financial statements.

## 5 Auditing standards and practice

Another essential foundation for effective disclosure in the corporate and financial sectors of the economy is the maintenance of sound and credible auditing standards and practices. Effective, high quality auditing of financial

information is essential if the information disclosed by corporate entities is to be, and be perceived to be, reliable and meaningful. This is especially the case where there is a strong degree of separation between the directors/managers of a corporate entity and its shareholders and creditors.

Sound auditing standards and practices require a number of features, including the following:

- The standard-setting body needs to be well resourced, independent of conflicts of interest and capture by particular interests, and subject to robust and credible accountability and transparency arrangements. There needs to be a credible degree of separation between the accounting profession and the auditing standard-setter.
- International auditing standards set by the International Federation of Accountants (IFAC) provide a useful base for national auditing standards. It is desirable that national auditing standards are consistent with the international standards on auditing issued by IFAC. However, there is scope for national auditing standards to go beyond those set by IFAC, having regard to the particular circumstances of the national accounting profession and institutional arrangements.
- For international auditing standards to have wide acceptability, there is a need for IFAC to be a truly international standard-setting body, with representation from a wide range of countries.
- International auditing standards should be subject to thorough international consultation before promulgation. National auditing standards should also be subject to a thorough process of consultation with all interested parties (and not just the accounting profession). The standard setting process should be transparent and accountable.
- For auditing standards to be effective, they must be subject to compliance monitoring and enforcement by a well-resourced, independent and accountable body with the authority and incentives to take appropriate disciplinary action for non-compliance with auditing standards.

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- Auditing requires a credible degree of independence for the auditor. Various options are available to encourage auditor independence, including mandatory rotation of audit partners, rotation of audit firms, minimum cool-down periods for auditors, separation between audit and non-audit activities, and disclosure of audit and non-audit fees paid to the auditor.
  - Regular peer review of audits by auditors from other audit firms can be an effective way to enhance standards in the auditing profession.
  - The company should have a strong culture of business ethics, accountability and transparency, with the board taking leadership in ensuring that this culture is strongly adopted and maintained throughout the company.
  - The board should maintain systems and structures to regularly oversee the company's financial performance and position, cashflow, risks, and risk management capacity. These systems and structures should be reviewed periodically by external parties with a credible degree of independence and expertise. The board should regularly assess the performance of the management team.

## 6 Corporate governance

Another important foundation for effective financial disclosure is sound corporate governance. Robust governance policies and practices in corporate entities help to foster a disclosure culture and encourage the systems and structures needed to produce reliable and timely disclosure. High quality and timely disclosure in turn helps to reinforce sound governance practices by reinforcing the incentives for the directors and senior managers of a corporate entity to ensure that their company has reliable systems in place to identify, monitor and control the business risks of the company.

There are many international and national codes on corporate governance that provide guidance on the key principles of good corporate governance, including the OECD Principles on Corporate Governance. In particular, the following elements of corporate governance are helpful in promoting sound disclosure practices:

- The board of a corporate entity should comprise directors with the skills, knowledge and experience necessary to have a sound understanding of the company's business and risks. Directors should be in a position to devote the time and attention required in order to perform their role effectively.
- The board should comprise a number of non-executive and independent directors capable of exercising careful scrutiny of management and of the company's dealings with related parties, including a controlling shareholder.
- The board should ensure that the company has a well resourced internal audit function, where the internal auditor has a capacity to report to the board audit committee or directly to the board.
- Management should report on a regular and comprehensive basis to the board, providing the board with the information needed to assess the company's performance and position, including in relation to its risks, risk management systems, breaches of risk limits, financial performance, balance sheet and off-balance sheet, among other matters.
- The board should take ultimate responsibility for the completeness and veracity of all financial disclosures issued by the company; disclosure statements should be signed off by the directors as being accurate, complete and not misleading.
- A board audit committee should oversee the internal and external auditing process and should be chaired by a non-executive, independent director and comprise only non-executive members of the board. The audit committee should regularly meet with the internal and external auditors without management or executive directors being present, and should formally assess the performance of the internal and external audit functions.
- The board should regularly assess its own performance as a board, including through the occasional use of external assessment procedures.

- Shareholders should have the ready capacity to appoint and remove directors.
- It is desirable for the non-executive directors of the board to meet regularly without executive directors or members of the management team being present, including for the purpose of assessing the performance of the senior management team.
- The board should regularly assess the adequacy of the company's financial and risk-related disclosures, including by reference to relevant professional standard, external benchmarks, peer group comparisons and through user group assessments.
- Market disciplines are likely to be encouraged in an environment where market prices are not excessively distorted by regulation, taxation or subsidies, such that they can adjust to demand and supply conditions quickly and with minimum friction. Equally, market disciplines will be more effective in situations where investors and creditors can move their funds readily into and out of particular companies or markets, with minimal transaction costs and other frictions.
- Market-based incentives for disclosure are likely to be stronger in situations where investors and creditors bear at least some of the consequences of their investment and funding decisions. Unlimited deposit insurance, government ownership of corporate entities, government guarantees or implicit government support of corporate and financial entities weaken the effectiveness of market discipline. In the case of financial institutions, it is especially important that deposit insurance schemes are structured with limits to the level and scope of deposits protected and that these limits be firm and credible. Given that the objectives of most deposit insurance systems include the protection of small and less sophisticated depositors, coverage limits can be set at relatively low levels and still protect the majority of these depositors. It is also important that central banks and supervisory authorities maintain the capacity to manage bank distress and failure episodes in ways that preserve or strengthen market disciplines. This can best be done by ensuring that the depositors and other creditors of failed banks are not protected from losses (other than in respect of deposit insurance applicable to insured deposits).

## 7 Market-based incentives for disclosure

Although accounting and auditing standards, and associated enforcement processes, are essential foundations for effective financial disclosure in the corporate and financial sectors, so too are market-based incentives. Strong market disciplines on financial statement issuers help to foster an environment conducive to high quality financial disclosure. Market disciplines on the accounting and auditing professions are also important factors in encouraging sound disclosure practices.

For market discipline to be effective, it requires stakeholders of companies to have the incentives and information to monitor the financial performance of companies, and the ability to exert discipline on companies, such as through a company's share price, price of credit or access to credit.

Market disciplines can be fostered in a number of ways, including the following:

- Market disciplines are generally fostered through contestable and competitive markets, including financial markets and in the corporate sector, and in the accounting and auditing profession.
- A competitively neutral regulatory framework, where "like" entities are regulated on the same basis, can help to promote a competitive environment and strong market incentives for disclosure.

## 8 Encouraging use of disclosure statements

Market-based incentives for disclosure are also strengthened by encouraging and assisting investors, creditors, depositors, financial analysts, the news media, among others, to see and understand financial disclosures. Options for achieving this can include the following:

- User-friendly formats for disclosures can assist investors, creditors and other stakeholders with limited time and expertise to access and digest financial disclosures. For example, short-form disclosure statements made available on web sites and/or in branches and other offices of a corporate entity or financial institution can facilitate access to financial disclosures.
- Disclosure of key financial and prudential ratios can also assist investors, creditors and other stakeholders to understand financial disclosures, by drawing to their attention the most salient financial and risk-related features of a corporate entity. This can be particularly effective when these ratios are disclosed in readily accessible format, such as short-form disclosure statements.
- Guidance material for investors, creditors and other stakeholders can help to promote a stronger understanding of financial information and assist in the interpretation of financial statements and key ratios.
- Encouraging the news media to take an interest in financial disclosures by corporate entities, including through the use of news media briefings and educational sessions, can also help to make financial disclosures more accessible to stakeholders.

## 9 Disclosures by financial institutions

Although financial disclosure is of fundamental importance in the corporate sector generally, it is of particular importance in the financial sector. This reflects the central role that the financial sector plays in the economy and the costs to the economy associated with financial instability. High quality, regular and timely disclosure by financial institutions can help to reduce the risk of financial instability and encourage sound risk management practices within the financial sector. It strengthens the incentives for the directors and managers of financial institutions to ensure that their institutions' risks are being controlled effectively. It also provides a basis for depositors and other creditors to make better

informed decisions as to where to place their funds, thereby strengthening market disciplines on financial institutions.

In addition to the standard features of high quality disclosure required in the corporate sector generally, particular disclosure requirements for the financial sector can include the following:

- Disclosure by financial institutions should desirably be relatively frequent, such as quarterly, given that a financial institution's risk positions can change significantly over a short period. Consideration can also usefully be given to requiring financial institutions to disclose positive or adverse material developments intra-quarter where these are sufficiently material as to be likely to affect an assessment of the soundness of the financial institution by investors, depositors or other stakeholders.
- Disclosure should desirably be in relation both to the licensed financial institution on a solo basis and the consolidated group of which it is part. Off-balance sheet positions should be included in the information disclosed by a financial institution.
- Disclosures should include comprehensive information on financial performance, financial position and risk positions, including liquidity risk, exchange rate risk, interest rate risk, equity risk, exposure concentration risk, exposures to related parties, sectoral risk positions, impaired assets, provisioning, capital adequacy, and other relevant risk-related information. Disclosures in relation to risk positions should ideally apply both at the end-of-period and on a peak or trough end-of-day intra-period basis.
- It can be useful to require financial institutions to disclose the results of stress tests, particularly in relation to stress tests for credit losses, interest rate shocks and exchange rate shocks.
- It can be desirable to require financial institutions to disclose their credit rating (if they have one), the name of the rating agency, and any changes to the rating in the previous two or three years.
- It is desirable to require financial institutions to disclose the structures and processes they have in place to

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maintain high quality corporate governance and risk management systems, including the nature of any external review conducted of their corporate governance and risk management systems.

- It is desirable to require the directors and chief executive officer of a financial institution to sign their financial institution's disclosure statements and to be held liable, civilly and criminally, for the veracity of the disclosures.
- Disclosures should desirably be in forms that can be readily accessible and understood not only by financial analysts and professional investors, but also by the ordinary depositor. This might suggest the need for requiring financial institutions to issue disclosures in at least two forms – a comprehensive disclosure statement for the professional analyst/investor, and a short-form disclosure statement for the depositor. The latter could be made available in bank branches. Both could be made available on a financial institution's website and in hard copy.

## 10 Conclusion

Taken as a whole, the measures set out in this paper will go a long way towards promoting sound financial disclosure in the corporate and financial sectors of the economy. However, they need to be underpinned by a culture of transparency and high business ethics. And this needs to be instilled from the top, including in the day-to-day policies and practices of political leaders, national and local government, and in state-owned entities. Therefore, there needs to be a broad-based and sustained commitment to transparency and ethical conduct throughout the community – at all levels – in order for a culture of effective disclosure to take root and flourish in the corporate and financial sectors of our economies.