

## **Financial reporting in the global economy: Facilitating better business and investor decision-making**

**Date:** 29 October 2015

**Speaker:** Lynn Wood, Trustee, IFRS Foundation

**Venue:** Australian Finance & Treasury Association Annual Conference, Melbourne, Australia

### **Introduction**

It is an honour to join you today. My name is Lynn Wood, and among other roles I serve as a Trustee of the IFRS Foundation. The IFRS Trustees from around the world oversee the work of the International Accounting Standards Board (IASB) and its work to develop a global language of financial reporting, known as International Financial Reporting Standards, or IFRS. I am also a former Chairman of the Australian Financial Reporting Council (FRC) and have served on a number of boards during my business career.

I should note at the beginning that the Trustees are not accounting experts, nor do we get involved in the technical work of the IASB. However, I am keen to make sure Australia is a vocal participant in those discussions with the IASB.

As a capital-importing country, Australia has always been a leader in high quality financial reporting. It therefore made perfect sense for Australia to be among the first wave of countries adopting IFRS in 2005. Australian companies report against both Australian accounting standards, which are identical to IFRS for for-profit entities, and IFRS. Since 2005, more than 100 other countries have adopted IFRS as their domestic reporting standard, while most of the remaining countries permit its use. There are a few remaining major countries that have yet to decide whether and how to adopt IFRS, including China, India, Japan and the United States. However, even in these countries we have seen many positive developments towards IFRS. Japan in particular has made remarkable progress in the last few years, with companies representing around 20% of Japanese market capitalisation now choosing to report using IFRS. Japan has even introduced a new stock exchange index related to IFRS.

Among the qualitative factors for screening entities to be covered by the index is adoption or scheduled adoption of IFRS.

I was in China this month for an IFRS Trustees' meeting and we noted that Chinese Accounting Standards are already substantially similar to IFRS, while Chinese companies representing more than 30 per cent of total Chinese market capitalisation already report using IFRS for the purpose of their dual listings in Hong Kong. Furthermore, we understand that the new Asian Infrastructure Investment Bank intends to report using IFRS.

Since 2007, the United States has allowed non-US companies to report using IFRS. US companies are not yet allowed to use IFRS in the US although many subsidiaries of US companies abroad report using IFRS.

I strongly believe that the momentum is now unstoppable towards every country in the world adopting IFRS, and so the question is no longer 'if' but 'when' we will have truly global accounting standards.

## **Relevance of financial reporting**

So, why does any of this matter to Corporate Treasurers?

Quite simply, because as Treasurers, you are placing huge, long-term bets on behalf of your company that are based on numbers produced or reported in accordance with IFRS. If I were in your position, I would want to know more about the basis on which those numbers are prepared, and whether that basis is likely to change in the near future.

No one expects treasury people to be financial reporting experts. However, in my view, it is important that treasury and financial reporting teams should co-operate closely. For example, care needs to be taken when considering the financial reporting implications of liquidity management and debt issuance. Moreover, the IASB has issued or is about to issue a number of important new accounting standards that may affect balance sheet valuations or even cause doubt over the actual existence of some assets and liabilities. Three clear examples are IFRS 9 *Financial Instruments* and IFRS 15 *Revenue Recognition*, both effective from 2018, and the IASB's impending Standard on *Lease Accounting*. IFRS 9 and 15 have already been adopted into Australian accounting standards. These will all be substantial changes to financial reporting, that you as Treasurers need to be familiar with.

I hope that I now have your attention! So, let's begin with a quick recap.

Financial reporting is more than accounting. It is a standardised language of communication between market participants. A lexicon for capital markets, if you like. In the 21<sup>st</sup> century, capital markets are mutually dependent and globally interconnected. As a country that looks both East and West, Australian capital markets are the perfect example of this.

Before IFRS, pretty much every country in the world maintained its own set of national accounting standards, of varying quality. Today, IFRS has become the “lingua franca” of international business and commerce, spoken around the world—even in those jurisdictions that have yet to fully adopt.

## **Better investor decision-making**

IFRS is very much aimed at helping investors to allocate capital in the most effective manner, by providing them with trusted, high quality and internationally comparable financial information on which they can make investment decisions.

IFRS brings transparency, accountability and efficiency to financial markets around the world. It serves the public interest by fostering trust, growth and long-term financial stability in the global economy.

Now, these are grand statements. But how can we talk about financial stability when we have just lived through a financial crisis of such monumental proportions?

The global financial crisis did not come about because of poor accounting standards. There were many other reasons for the crisis. However, many people believe that the greater transparency resulting from more recent enhancements to IFRS will play an important role in avoiding future crises, and will thus contribute to financial stability over the longer term.

For example, in 2011 the IASB introduced IFRS 13, *Fair Value Measurement*, which provides investors with much better information about the assumptions involved in applying mark-to-market accounting. IFRS 13’s requirements include disclosures of the now-familiar three-level hierarchy of fair value measurement.

Last year, the IASB issued IFRS 9, *Financial Instruments*, which again provides investors with substantially more information about the use of financial instruments. It introduces a forward-looking expected credit loss model that will result in more timely recognition of loan losses. And, which will be of much interest to Treasurers, the IASB also radically overhauled hedge accounting requirements to better align the economics of risk management to its accounting treatment.

The resulting increases in transparency will help regulators have greater visibility of risks building in the system, and will also help investors to understand any risks that are buried deep within the balance sheet. To paraphrase former US Defence Secretary Donald Rumsfeld, it is the unknown unknowns that are most difficult to deal with. For investors, IFRS helps to reveal these risks. In turn, this information contributes to a focus on achieving higher investment returns and greater financial stability over the economic cycle

## Better business decision-making

As well as helping investors, IFRS can help companies and their boards make better decisions. As Sir David Tweedie, the former Chairman of the IASB once said, financial reporting is all about keeping capitalism honest. The transparency resulting from IFRS also provides a company's board with better information on which to make informed business decisions. This is particularly true for financial instruments, famously described by Warren Buffett as 'financial weapons of mass destruction', which can pose an existential threat to any company, and with it, the careers of its senior management and non-executive directors!

When every international operation, and every subsidiary, is using the same basis on which to prepare financial information, then businesses can operate more efficiently and the risks and costs of preparing multiple sets of books can be avoided.

Australia, as a capital importing country, recognised the benefits of IFRS early and mandated the use of IFRS from 2005, as did the European Union. Based on a different approach Japanese companies were allowed to voluntarily elect to switch to IFRS from 2010. In the last two years we have seen many of Japan's largest, most internationally-oriented companies voluntarily adopt IFRS. One of the main reasons cited for doing so has been 'management efficiency'.

Of course, it is also true that IFRS and financial reporting in general are a long way from being perfect. One of the most frequent criticisms I hear is the ongoing concern about complexity in financial reporting. This is an issue that the FRC identified in our strategic plan during my time as Chairman. We created a task force to look into how best to deal with complexity in financial reporting. Originally it was called the Reducing Complexity Task Force however, after a few meetings, the group, led by the BCA representative on the FRC, realised they could not reduce complexity, they could only suggest ways of managing it, so they changed the name.

The report issued in 2012 identified many root causes of complex financial reporting, such as increasingly complex business operations, complexities in the regulatory framework and increased risk-aversion by directors, companies and their auditors in response to a more litigious business environment.

At the same time, the report also suggested that the IASB should consider improvements in the requirements for financial disclosures as well as a clearer definition of 'Other Comprehensive Income'. I am pleased that the IASB has taken on board this feedback from Australia and elsewhere in the world, and is making good progress in each of these areas. In a speech entitled 'Breaking the Boilerplate', IASB Chairman Hans Hoogervorst has set out a 10-point plan to improve the usefulness

of financial disclosures, while the IASB is close to finalising the much-needed update to its *Conceptual Framework*.

Another task force that we established aimed to address board financial literacy, led by the ASX member on the FRC. Our strategic plan recognised that non-executive directors are finding it very difficult to understand financial reports, due largely to their increasing complexity. Given each director is personally responsible for signing off on the financial report, financial literacy is very important for board members. One of the outcomes of the report was a free quiz for director financial literacy which is now on the [ASIC website](#).

You may like to try the quiz- or suggest that your directors try it! You can also contribute to director financial literacy by helping to educate directors by clearly explaining aspects of your role, especially any use of financial instruments. For example, the Treasurer for a company of which I was a director wanted to include derivatives with optionality in the investment policy however he could not explain why this optionality was of value so the board decided only to include vanilla derivatives in the policy. I'm sure, given your interest in attending this conference, you could explain points in your investment policy much more effectively.

## **Actions to take**

I hope that I have spiked your interest about relevance of IFRS and financial reporting to Treasurers. So what practical steps should you take to better understand the issues and to keep informed?

First and foremost, you need to be familiar with developments in IFRS and how they may affect your company, because capital providers, and others around the world with whom you interact, will be familiar with up-to-date IFRS and will expect you to be as well. For example, the consequences of changes in the balance sheet resulting from proposed changes to IFRS are very relevant to Treasurers, because they can affect credit ratings and hence the cost of debt. As well as staying close to your own financial reporting teams, the IASB provides some excellent high level materials on its website. In particular, I highly recommend the high level summaries dealing with IFRS 9 *Financial Instruments*, IFRS 13 *Fair Value Measurement* and IFRS 15 *Revenue Recognition*. You can also register to receive free email alerts from the IASB's website as well as from the Australian Accounting Standards Board (AASB) website.

Second, you need to get involved in the process at an early stage. Modern economic history has seen enlightened organisations move from competition, through co-operation and now to collaboration. Collaboration is characterised by high trust, intrinsic motivation, open and shared communications and the goal of working together to achieve new solutions. IFRS is a wonderful example of such collaboration. I have never seen a better model of collaboration.

Can you imagine being involved with a group that is liaising with countries worldwide to encourage them to stop use of their standards and adopt a new set that has been agreed by others? You can't do this without high levels of collaboration. The IFRS Foundation and the IASB are very receptive to feedback. The AASB is also very active in seeking feedback, holding roundtables and education sessions, often in conjunction with the IASB. You may find participating in these events easier than giving formal written feedback. We are working hard to ensure that IFRS can be fully applied on a globally consistent basis, across both developed and emerging economies.

So if you don't think that something is working within an Australian context, or if you have ideas about how financial reporting can be improved or have thoughts on how we can be more effective in the standard-setting process, please let us know. Right now, the IFRS Foundation Trustees are consulting on the structure and effectiveness of the IFRS Foundation, while the IASB is consulting on its agenda for the next three years. Comments need to be received by the end of November on the Trustees' consultation and by the end of December on the IFRS Foundation's agenda consultation, so do get involved. Other countries are doing so, and we need to make sure that Australia continues to be a vocal participant in this important work given our leading role in adopting IFRS.

## **Close**

Ladies and gentlemen, I appreciate your time and attention. I have set out to provide you with a brief update on IFRS, and how it contributes to better investor and business decision-making. I urge you to find out more and to get more involved in our work and I wish you a successful conference.