

## EUROPEAN COMMISSION EVALUATION OF THE INTERNATIONAL ACCOUNTING STANDARDS (IAS) REGULATION: A PERSPECTIVE FROM THE STAFF OF THE IFRS FOUNDATION

September 2014

The European Commission is undertaking an evaluation of Regulation 1606/2002 (the IAS Regulation). As part of its evaluation, the Commission is holding a public consultation to seek views from all interested parties on their experience of the IAS Regulation. The consultation questionnaire is available on the Commission's website<sup>1</sup> and the deadline for responses is 31 October 2014.

The IFRS Foundation encourages all interested parties to respond to the Commission's consultation. The purpose of this paper is not to respond to the questions in the consultation document, but rather to offer a perspective from the staff of IFRS Foundation<sup>2</sup> on some of the main issues highlighted in the questionnaire.

### Relevance of the IAS Regulation

In its consultation, the Commission asks whether the IAS Regulation has furthered the move towards establishing a set of globally accepted high-quality standards. When the IAS Regulation was adopted in 2002, few jurisdictions/companies used IFRS. The evidence is clear that the growth of IFRS has expanded enormously since then. In July 2014, the IFRS Foundation published the findings of a major research project *IFRS as global standards: a pocket guide*, which was undertaken to obtain a full picture of IFRS use around the world. That research<sup>3</sup>, verified by the relevant jurisdictional authority in each of the 130 countries surveyed, shows that 105 countries (81 per cent of those surveyed), now mandate the use of IFRS for all or most public companies. While Europe remains the largest single user, the combined Gross Domestic Product (GDP) of non-European jurisdictions using IFRS, as US\$23 trillion, now exceeds the combined EU-GDP of US\$17 trillion.

The results of the research also show that almost all of the remaining countries that have yet to require the use of IFRS for domestic purposes already permit its use in certain circumstances. For example, Japan has for some time permitted the voluntary use of IFRS, with around 40 companies having adopted or officially announced voluntary adoption of IFRS, while the Japanese government views encouraging greater use of IFRS as a fundamental element of its recently announced growth strategy. India also permits voluntary use of IFRS and the Indian government has announced its intention to converge the current Indian accounting standards with IFRS. Around 250 of China's largest companies report using full IFRS (or Hong Kong standards, which are identical to IFRS) for the purpose of their dual listings in Hong Kong, while the United States has since 2007 allowed non-US companies to report using IFRS as issued by the IASB. Furthermore, investors in these countries are often prolific users of IFRS-based financial statements.

IFRS are now part of the global financial architecture and are among the 12 key International Standards and Codes that have been designated by the Financial Stability Board (FSB), of which the IASB is a member, as being key for sound financial systems and deserving of priority implementation

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<sup>1</sup> The consultation page is at: [http://ec.europa.eu/internal\\_market/consultations/2014/ifrs/index\\_en.htm](http://ec.europa.eu/internal_market/consultations/2014/ifrs/index_en.htm).

<sup>2</sup> This paper is published as a convenience to interested parties and has not been approved by either the IASB or the Trustees of the IFRS Foundation.

<sup>3</sup> The details of the research are available at: <http://www.ifrs.org/Use-around-the-world/Pages/Jurisdiction-profiles.aspx>.

depending on country circumstances. These standards are broadly accepted as representing minimum requirements for good practice that countries are encouraged to meet or exceed<sup>4</sup>.

The IFRS Foundation staff note that, in the final report on his mission in 2013 to reinforce the EU's contribution to international accounting standards, Philippe Maystadt, Special Advisor to Commissioner Barnier, observed "a wide consensus on the commitment to global quality accounting standards"<sup>5</sup>, based on his consultations with stakeholders, and highlighted the particular significance of the global character of IFRS, which he noted has brought positive effects in terms of the quality and comparability of financial reporting<sup>6</sup>.

### The benefits of IFRS

The Commission is also seeking views on the benefits of applying IFRS. On this issue, in 2012, the IFRS Foundation commissioned Ann Tarca, Professor of Accounting at the University of Western Australia and a former Academic Fellow of the IASB, to examine and summarise current academic research that has sought to observe and quantify the benefits derived from widespread adoption of IFRS. In summary, the research finds that capital markets benefit after adopting IFRS<sup>7</sup>, even in countries with strong investor protection and high quality financial reporting and enforcement. Such benefits include<sup>8</sup>:

- (a) market efficiency—market liquidity increases following the introduction of IFRS, while firms benefit from a reduction in the cost of capital and an increase in equity value;
- (b) investment decisions—analysts that review IFRS firms have more accurate forecasts compared to those forecasts of analysts following non-IFRS firms. Furthermore, when a country's GAAP is closer to international standards, foreign analysts are more likely to follow and provide more accurate forecasts for firms in that country;
- (c) quality of financial information—in Europe, there was a general perception among preparers, auditors, investors and enforcers that the application of IFRS has improved the comparability, quality and transparency of financial reporting;
- (d) foreign investment—IFRS is a vehicle through which countries can improve investor protection and make their capital markets more accessible to foreign investors;
- (e) capital market integration—higher correlations of market indices were observed between markets in which firms use IFRS and markets in which firms generally do not use IFRS;
- (f) method of application—the success of common standards depends not just on the quality of the Standards issued by the IASB. Critically, success also requires an infrastructure to support IFRS to be in place at a national and international level.

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<sup>4</sup> FSB website *Key Standards for Sound Financial Systems*, at [http://www.financialstabilityboard.org/cos/key\\_standards.htm](http://www.financialstabilityboard.org/cos/key_standards.htm).

<sup>5</sup> Philippe Maystadt (2013) *Should IFRS Standards be More "European"?: Mission to reinforce the EU's contribution to the development of international accounting standards*, page 7, available at: [http://ec.europa.eu/internal\\_market/accounting/docs/governance/reform/131112\\_report\\_en.pdf](http://ec.europa.eu/internal_market/accounting/docs/governance/reform/131112_report_en.pdf).

<sup>6</sup> Philippe Maystadt (2013), as footnote 5, page 4.

<sup>7</sup> Ann Tarca (2012) *The Case for Global Accounting Standards: Arguments and Evidence*, available at <http://www.ifrs.org/Use-around-the-world/Documents/Case-for-Global-Accounting-Standards-Arguments-and-Evidence.pdf>

<sup>8</sup> As listed in IFRS Foundation (2012) *Report to the Trustees of the IFRS Foundation: IFRS Foundation staff analysis of the SEC Final Staff Report – Work Plan for the consideration of incorporating IFRS into the financial reporting system for US issuers*, page 66, available at: <http://www.ifrs.org/Use-around-the-world/Global-convergence/Convergence-with-US-GAAP/Documents/Analysis-of-SEC-Final-Staff-Report.pdf>.

The use of IFRS globally by EU companies, without the need for restatement, has provided them with the benefit of achieving improved group reporting and administrative savings through having to only report under one accounting framework.

### **Endorsement mechanism and criteria**

The Commission consultation also seeks the views of interested parties on the endorsement procedure by which IFRS are adopted on a standard-by-standard basis for use in the EU. The IFRS Foundation staff note that this is another issue that was examined by Philippe Maystadt as part of his mission. In his final report, Mr Maystadt emphasises the support for the maintenance of such as standard-by-standard adoption procedure. In its comments on the Maystadt report, published in December 2013<sup>9</sup>, the IFRS Foundation welcomed this emphasis.

The IFRS Foundation's research on the use of IFRS referred to above reveals that the 130 jurisdictions have made very few modifications to IFRS, and the few that have been made are generally regarded as temporary steps in the jurisdiction's plans to adopt IFRS. For example, the EU itself describes its IAS 39 'carve-out' as 'temporary', and the 'carve-out' has been applied by fewer than two dozen banks out of the 8,000 or so IFRS companies whose securities trade on a regulated market in Europe. The IASB currently has projects on its agenda, or has recently finalised projects, to address most of the other modifications, including use of the equity method to account for subsidiaries in separate company financial statements; loan loss provisioning; and accounting for rate-regulated activities. A few jurisdictions have deferred the effective dates of some Standards, particularly IFRSs 10, 11 and 12 and IFRIC 15. The IFRS Foundation has set out its view that the fact that IFRS are being used in most jurisdictions without modification provides an important contribution to growth and transparency in the global economy.

The Commission has itself warned of the downsides of non-endorsement. A Staff Working Document issued in 2012 commented that:

“A refusal by the European Parliament and Council to endorse one or more IFRS would undermine the implementation of the IAS Regulation, of the Transparency Directive and of the Prospectus Directive, possibly triggering a damaging political debate about the continued appropriateness of IFRS as a whole for the EU. Such an outcome would undermine the functioning of the Single Market and, in particular, of the EU's capital market”<sup>10</sup>.

The Commission questionnaire notes that Mr Maystadt's report refers to the possibility of introducing new criteria for the adoption of IFRSs in the EU, ie that they should not endanger financial stability and must not hinder the economic development of the region. In the comments on the Maystadt report, the IFRS Foundation expressed its support for the goals of financial stability and economic growth and a belief that IFRS make a contribution to both by providing transparency to the capital markets. Those comments also flagged up concerns that accounting standards should not be “instrumentalised” with a view to hiding or twisting the objective representation of the situation and the performance of businesses.

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<sup>9</sup> IFRS Foundation (2013) *IFRS Foundation issues comments on the Maystadt Report*, available at:

<http://www.ifrs.org/Alerts/PressRelease/Pages/IFRS-Foundation-issues-comments-on-the-Maystadt-Report-December-2013.aspx>.

<sup>10</sup> Document SWD(2012)444 final of 19 December 2012, *Ex-ante evaluation for establishing a Union Programme to support specific activities in the field of financial reporting and auditing*, available at: <http://register.consilium.europa.eu/doc/srv?l=EN&f=ST%205214%202013%20INIT>.

The 2009 *Report of the Financial Crisis Advisory Group*<sup>11</sup> examines the intersection between financial reporting and prudential and how both accounting standard-setters and prudential regulators serve the public interest in accordance with their respective missions. The Financial Crisis Advisory Group (FCAG)<sup>12</sup> emphasised that financial reporting, by providing only a snapshot in time of the economic situation and performance, cannot provide perfect insight into the effects of macroeconomic developments. However, what it does do is provide as unbiased and relevant information as possible about the economic performance and condition of businesses in a way that provides confidence to investors and other capital market participants in the transparency and integrity of that information.

The IFRS Foundation staff note that that view is shared by others. For example, Steven Maijoor, the Chair of the European Securities and Markets Authority (ESMA) is on record as commenting that:

“I believe that accounting standards do contribute to financial stability by providing clear principles on how to account for complex transactions, such as financial instruments, and by favouring transparency: transparency being key for good market functioning and good market functioning being an essential component of financial stability”<sup>13</sup>.

The Commission consultation also seeks views on whether it should have more “leeway” to modify standards to be adopted for use in the EU. As might be expected, in its December 2013 comments, the IFRS Foundation noted the very real risks of such flexible endorsement, in particular the negative signal that it would give to the rest of the world.

### Quality of IFRS financial statements

The Maystadt report includes a comment that the stakeholders interviewed noted that IFRS has improved the quality, comparability and reliability of financial information<sup>14</sup>. In addition, the IFRS Foundation staff also observe that ESMA produces annual reports on the *Activities of the IFRS Enforcers in Europe*<sup>15</sup>. These reports have commented on the continued improvements in the quality of IFRS financial statements as a result of the significant experience gained by preparers since 2005. That said, the IFRS Foundation staff acknowledge that the ESMA activity reports also comment that there is room for improvement in the quality of financial reporting in certain areas.

### Enforcement

The IFRS Foundation’s objectives include the development of, in the public interest, a single set of high quality, understandable, enforceable and globally accepted financial reporting standards (IFRSs) and the promotion of their use and rigorous application<sup>16</sup>. In their *Report of the Strategy Review 2011*<sup>17</sup>, the Trustees of the IFRS Foundation noted that the organisation has a vested interest in helping to ensure the consistent application of IFRS internationally and recommended, among other things, that the IASB should work with securities regulators to pursue that objective. Ann Tarca’s

<sup>11</sup> The FCAG report can be accessed at: <http://www.ifrs.org/News/Press-Releases/Documents/FCAGReportJuly2009.pdf>.

<sup>12</sup> The FCAG was a high level group of recognised leaders with broad experience in international financial markets that was formed at the request of the IASB and the US Financial Accounting Standards Board (FASB) to consider financial reporting issues arising from the crisis.

<sup>13</sup> The speech was delivered to an IFRS Conference in July 2011 and is available at: [http://www.esma.europa.eu/system/files/2011\\_202.pdf](http://www.esma.europa.eu/system/files/2011_202.pdf).

<sup>14</sup> Philippe Maystadt (2013), as footnote 5, page 7.

<sup>15</sup> The reports can be accessed from the ESMA IFRS Enforcement page at: <http://www.esma.europa.eu/page/IFRS-Enforcement-0>.

<sup>16</sup> IFRS Foundation (2013) *Constitution*, section 2, available at: <http://www.ifrs.org/The-organisation/Governance-and-accountability/Constitution/Documents/IFRS-Foundation-Constitution-January-2013.pdf>.

<sup>17</sup> IFRS Foundation (2012) *Report of the Trustees’ Strategy Review 2011 - IFRSs as the Global Standards: Setting a Strategy for the Foundation’s Second Decade*, available at: <http://www.ifrs.org/About-us/IFRS-Foundation/Oversight/Strategy-Review/Documents/TrusteesStrategyReviewFeb2012.pdf>.

research, referred to above, notes that the benefits of IFRS depend on the level of enforcement in a jurisdiction.

In pursuit of this objective, the IFRS Foundation has worked to deepen its cooperation with securities regulators. In September 2013, the IFRS Foundation and the International Organisation of Securities Commissions (IOSCO) agreed a *Statement of Protocols for Cooperation on International Financial Reporting Standards*<sup>18</sup>, under which the two organisations agreed to deepen their cooperation in both the development of IFRS and implementation of IFRS on a globally consistent basis.

Within Europe, the IFRS Foundation and ESMA have, for years, cooperated to support the consistent application of IFRS. In July 2014, the IFRS Foundation and ESMA announced the agreement of a joint *Statement of Protocols* to serve as the basis for future co-operation in areas of mutual interest<sup>19</sup>. Under the agreement, IASB members and staff meet with the European Enforcers Coordination Sessions (EECS)<sup>20</sup> regularly, and as necessary for urgent matters, to discuss current enforcement issues, and developments at the IFRS Interpretations Committee.

The IFRS Foundation staff note that the activities conducted at European and Member State level, as coordinated by ESMA, with respect to examining compliance of financial information with IFRS are well documented in ESMA's annual reports on the *Activities of the IFRS Enforcers in Europe*, referred to above. ESMA also undertakes useful reviews of compliance in specific areas of accounting. For example, in November 2013, ESMA published a review of the comparability and quality of disclosures in 2012 IFRS financial statements of listed financial institutions<sup>21</sup>. Periodically, ESMA also publishes extracts from its confidential database of enforcement decisions on financial statements, with the aim of providing issuers and users of financial statements with relevant information on the appropriate application of IFRS.

In July 2014, ESMA published its final *Guidelines on enforcement of financial information*<sup>22</sup>, the aim of which is to strengthen and promote greater supervisory convergence in existing enforcement practices among EU accounting enforcers.

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<sup>18</sup> IOSCO/IFRS Foundation Press Release 18 September 2014, available at: <http://www.ifrs.org/Alerts/PressRelease/Pages/IOSCO-and-IFRS-Foundation-agree-joint-protocols-September-2013.aspx>.

<sup>19</sup> ESMA/IFRS Foundation Press Release 15 July 2014, available at: <http://www.ifrs.org/Alerts/Governance/Pages/IFRS-Foundation-and-ESMA-sign-joint-Statement-of-Protocols-July-2014.aspx>.

<sup>20</sup> EECS is a forum, organised by ESMA, gathering 39 European enforcers from the 28 Member States and the 2 countries in the European Economic Area (EEA) who have responsibilities in the area of supervision and enforcement of financial information.

<sup>21</sup> ESMA (2013) *Review of Accounting Practices: Comparability of IFRS Financial Statements of Financial Institutions in Europe*, available at: [http://www.esma.europa.eu/system/files/2013-1664\\_report\\_on\\_comparability\\_of\\_ifrs\\_financial\\_statements\\_of\\_financial\\_institutions\\_in\\_europe.pdf](http://www.esma.europa.eu/system/files/2013-1664_report_on_comparability_of_ifrs_financial_statements_of_financial_institutions_in_europe.pdf).

<sup>22</sup> ESMA (2014) *Final Report: ESMA Guidelines on enforcement of financial information*, available at: [http://www.esma.europa.eu/system/files/2014-807\\_-\\_final\\_report\\_on\\_esma\\_guidelines\\_on\\_enforcement\\_of\\_financial\\_information.pdf](http://www.esma.europa.eu/system/files/2014-807_-_final_report_on_esma_guidelines_on_enforcement_of_financial_information.pdf).