Prepared Remarks of Sir David Tweedie,
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It is a great honour to be invited by the Empire Club of Canada to speak today. In preparing for this event, I reviewed the Empire Club's Website and noted the list of past speakers. You have had royalty, past presidents and prime ministers, and military heroes. I did not want to read too much into the invitation, but I assume that my presence here means that accounting standard-setters have been conferred new exalted status.

Or maybe the invitation to an accounting standard-setter is a reflection of the times. Somehow, the current credit crisis has brought the normally arcane area of accounting standards to the front pages of the financial press. Some have pointed their finger at accounting standards as the cause the crisis. Not surprisingly, I tend to disagree.

Today, I would like to tell you why I disagree, what the International Accounting Standards Board (IASB) is doing to address the issues raised as part of the credit crisis, and how International Financial Reporting Standards (IFRSs) can serve as one of the foundations of a sound financial reporting infrastructure for the world's capital markets.

Addressing the credit crisis

Time is too short to provide a thorough analysis of the current credit crisis, but it is evident that at the heart of the crisis were bad lending practices. Bad lending was then compounded by the absence of prices in the secondary markets for some structured credit products and concerns about the location and size of potential losses. This in turn led to funding difficulties caused by the reluctance to extend credit to a number of financial institutions thought to hold low-quality liquid assets. Financial reporting enters the scene by way of its requirements to value these assets and to alert the markets to risks associated with their existence.

It is undoubtedly difficult to value complex, illiquid, structured credit securities. Many of the loans were in fact shown at cost in the books of financial institutions. When recoverability of a loan is doubtful the loan has to be marked down, even under historic cost accounting, to the present value of the cash flows expected from the loan—that value would be fair value. No entity is ever allowed to disclose assets valued at more than their recoverable amount in its financial statements.

My personal view is that showing the changes in values of these securities, even if imperfect, provides much needed transparency and enables markets to adjust in a necessary, even if painful manner. I am not alone in this assessment. The CFA Institute, representing financial analysts throughout the world, asked its members whether fair value requirements for financial institutions improve transparency and contribute to investor understanding of the risk profiles of these institutions. Seventy-nine percent said yes. While a slight majority

believed that fair value is aggravating the credit crisis, 74 percent surveyed believed that fair value accounting improved market integrity.[1]

None of this is to say that the existing IFRSs are perfect, and clearly the IASB is willing to examine how to improve its standards in light of developments. In endorsing a plan drafted under the auspices of the Financial Stability Forum, the G-7 Finance Ministers and Central Banks stated, "The International Accounting Standards Board (IASB) and other relevant standard setters should initiate urgent action to improve the accounting and disclosure standards for off-balance sheet entities and enhance its guidance on fair value accounting, particularly on valuing financial instruments in periods of stress."

We at the IASB already have projects underway on financial instruments, fair value measurement, consolidations and derecognition. For our consolidations and derecognition projects, ones that directly address off-balance sheet issues, the IASB is committed to move the projects forward expeditiously. The IASB will also put together an advisory group to help us address the issue of valuing financial instruments in illiquid markets.

The credit crisis also has a broader lesson for the IASB as an international standard-setter—in a world increasingly dependent on international capital flows, accounting has an important role to play. This afternoon, I would like to share my vision of how the global adoption of IFRSs can play a positive role in the effective functioning of capital markets.

The possibility of a Global Standard

The real impetus towards global accounting standards began some ten years ago. In the midst of the Asian financial crisis, several companies whose financial statements seemed to indicate that they were secure, suddenly went bankrupt casting great doubt on the veracity of the statements and in particular the national accounting standards in use. While it is important not to overstate the role of accounting standards and practices in precipitating the Asian financial crisis, it is clear that confidence in financial reporting practices in that region disappeared. As a consequence, financing, much of it short term in nature and not subject to any capital controls, was withdrawn. Interest rates rose, investment ground to a halt, and an economic slowdown followed. In the aftermath of the crisis, it was unlikely that confidence in the existing or any revised national standards could be restored rapidly, indeed, if ever. The obvious choice was to move to an internationally accepted set of standards.

At that time, two sets of standards were used on an international basis, the (then) International Accounting Standards promulgated by the part-time International Accounting Standards Committee (IASC) and US generally accepted accounting principles (US GAAP). A three-year debate began that included the US Securities and Exchange Commission (SEC) and the European Commission. The result was the creation of the International Accounting Standards Board, largely modelled on the US Financial Accounting Standards Board (FASB).

The IASB began its work in April 2001. The mission given to us was and remains to create a single set of high-quality and principles-based global financial reporting standards that are used throughout the world's capital markets. Whether you are in Toronto, Tokyo,

[1] See http://www.cfainstitute.org/memresources/monthlyquestion/2008/march.html.

Tampa, or Turin, the accounting should provide the same answer for the same economic transaction.

Admittedly, our set objective was bold, and it is easy to lose sight that before 2001, very few countries and companies throughout the world were using International Accounting Standards. A significant body of opinion existed, not restricted to the United States, that US GAAP would eventually become the global norm for companies and investors operating in international capital markets. In many ways this view was not misplaced. Many of us who worked for one of the international accounting firms, many years ago were able to point to "global" on a map. It was a large place consisting of 50 states with sea on both sides – you lost partnership points if you suggested otherwise – but times have changed!

In little more than seven years, more than 100 countries throughout the world, including the 27 European Union member states, now require or permit the use of International Financial Reporting Standards (IFRSs). In 2007, Canada, Israel, Korea and Japan all announced their planned move towards IFRSs. The major emerging and transition economies of the world—Brazil, China, India, and Russia—are signing up to IFRSs in an effort to attract the investment necessary to finance their development.

There is clear momentum towards accepting IFRSs as a common financial reporting language throughout the world. Today, multinational companies are benefiting from reduced compliance costs associated with the removal of the need for the consolidation of different national accounts into a single statement to meet their home country's requirements. Investors are able to make comparisons of companies operating in different jurisdictions more easily. Regulatory authorities are now more able to develop more consistent approaches to supervision across the world.

You may have noticed that I did not mention the United States yet, but convergence between US GAAP and IFRSs has been steady and there is reason to believe that IFRSs will be adopted in the United States by US companies in the near future. In November 2007, the US SEC agreed to eliminate the reconciliation requirement, with immediate effect, for those non-US companies using IFRSs as prepared by the IASB. At the same time, the SEC is giving serious consideration to a proposal to permit US companies to use IFRSs.

The Memorandum of Understanding and the IASB-FASB work programme

The sea change in attitude in the United States towards IFRSs was made possible by the release of the SEC roadmap regarding the removal of the reconciliation requirement and the Memorandum of Understanding (MoU) agreed in February 2006 between the FASB and the IASB. The SEC's roadmap set out a process by which the SEC would eliminate the reconciliation requirement, provided the FASB and the IASB established a robust process of convergence that would continue following the reconciliation's elimination.

From the standard-setting standpoint, the incentive of the reconciliation's removal and the acceptance of the MoU was a revelation. The IASB and the FASB would no longer need to concentrate on a possibly endless series of changes to get the reconciliation removed. In consultation with the SEC and the European Commission, the IASB and the FASB agreed that trying to eliminate existing differences between two standards that are in need of significant improvement is not the best use of the FASB's and the IASB's resources—instead

a new common standard should be developed that improves the financial information reported to investors.

Under this arrangement, convergence work has run on two tracks. First, the goal by 2008 is to reach a conclusion about whether existing major differences in a few focused areas should be eliminated through one or more short-term standard-setting projects and, if so, complete or substantially complete work in those areas. For the IASB, this would mean considering changes in six targeted areas, including borrowing costs, joint ventures, government grants, segment reporting, impairment, and income tax. The FASB would also need to consider changes to six of their standards. At the same time, convergence would not need to exact replication of standards, but agreement on major principles. For example, in addressing borrowing costs the IASB removed the option to expense interest costs on loans used to finance the construction of an asset. Accordingly, both US GAAP and IFRSs now require capitalisation of such interest. The means by which this capitalisation takes place is similar but not identical – the US and international standards are now broadly the same. Word for word conversions would simply take too long.

I am happy to report that the great part of the short-term convergence is now complete.

Second, and more substantially, the MoU established the target of 2008 to have made significant progress on a number of areas identified by both Boards where current accounting practices of US GAAP and IFRSs are considered outdated. We indentified 11 areas originally. We have completed virtually identical business combinations standards already, eliminating an area that produced significant difference in financial results between IFRSs and US GAAP. We have also decided not to tackle intangible assets as part of the MoU.

This leaves us nine other projects to complete with the FASB. At the end of the process, the intention is to have identical standards. This should make any US transition to IFRSs easier.

My best estimate is that these MoU projects will be completed in 2011. These remaining projects include four of the projects that I mentioned earlier in the context of the credit crisis:

- Consolidations
- Fair value measurement—a project aimed at how one calculates fair value, not when one does
- Financial instruments
- Derecognition

The two Boards are now addressing a number of the more challenging conceptual issues in financial reporting. For example, our financial statement presentation is examining how financial statements are laid out and how they fit together.

We are examining the issues of revenue recognition, the differences between liability and equity and two other projects that I think are critically important—leasing and pensions.

I pick on pensions and leasing because these are two standards where existing accounting falls a long way short. Frankly, accounting is not rocket science. It is often said

of the professions that they try to surround their activities with mystique to confuse the layman. Accounting standards can do more than that – they frequently baffle many accountants so much so that few audit partners can complete an audit without relying on the advice of experts within the firm. My usual comment when confronted by many supporters of complicated accounting policies is: "Explain that to your granny".

Let's apply the "granny" test to the existing pensions standard. Suppose a pension fund is in equilibrium, having liabilities of $40 million matched by assets of a similar amount. If the value of the assets was to fall to $30 million and liabilities remained the same, the fund would have a deficit of $10 million. Under what is the most commonly used option of IAS 19[2], derived from the former US standard (only recently changed), the deficit is reduced:

a) to remove market 'noise' by a reduction of 10 percent of whatever is the higher of assets or liabilities—in this case liabilities, leading to a reduction of $4 million
b) by 'spreading' the remaining deficit of $6 million ($10 million minus the $4 million) over the expected working lives of the employees—say 10 years for this example.

The result is that deficit shown in the financial statements becomes $600,000. Explain that to your granny.

Furthermore, not only is the change in the value of a pension fund not reflected in the financial statements correctly but the annual cost of pensions charged against annual income is offset by the estimated long term return on the assets in the fund. Some of these estimated returns have been heroic! In the United States from 2000 – 2004, the income statements of the top 500 companies, recorded these estimated returns at $498bn. The actual return amounted to $197bn.[3] In other words, $301bn of phoney profits flowed through the profit and loss accounts of the top 500 American companies over a period of five years.

Let's turn to leasing. One of my great ambitions before I die is to fly in an aircraft that is on an airline's balance sheet. Why does this not occur? Because most aircraft are leased and the standards divide leasing into two types: operating leases and capital/finance leases in which (broadly speaking) the asset is owned for almost its entire life. For operating leases the only amount shown in the financial statements is the annual lease payments which are charged to the profit and loss account. For finance leases, the present value of the future payments under the lease is shown as a liability and on the other side of the balance sheet the right to the asset. Why aren't aircraft shown? This is because aircraft are not normally leased for their entire life. They are usually leased for only seven years; therefore, they fall into the operating lease category. But ask the airline the following questions:

- Q: Can the airline escape from the lease? A: No, it is committed to annual payments over the next seven years.
- Q: Can the airline measure the amounts it has to pay over seven years? A: Yes, it is written into the lease contract.

[2] See "Post Retirement Benefits, Outside the Corridor" Company Reporting No 199, January 2007, p 3.
[3] 'Pondering Pensions: How They Affected the S&P500 in 2004'
The Analyst's Accounting Observer May 27, 2005 (Revised June 27, 2005)

The definition of a liability is met. The airline has an obligation from which it cannot escape and which can be measured reliably. It should, therefore, show as a liability the present value of the payments that have to be made and on the other side the rights to the aircraft for the same period. These would not be trivial figures. The leasing volume for the year of 2006 amounted to $634bn [4] – and this was for only one year. Most of it was off balance sheet.

A principles-based approach going forward

Our plan is to attack all of the nine MoU remaining areas in a manner that would make our grannies proud, or at least prouder. I have picked on two of my favourite cases where accounting is needlessly complex or fails to reflect the economic facts, but there are certainly other examples. The question is where we go in the future.

- Can standards be written differently?
- Can we deal with the main issues related to a particular type of transaction (what is known as an 80% standard) leaving the other problems to be dealt with by reference to the standard's main principles and the use of professional judgement?

The answer lies partly in developing standards that make intuitive sense. As we have learned, we simply cannot account and anticipate for all developments in the marketplace.

The core principles would have to be clearly stated. Other sub-principles should be related to these in a tree-like structure. Inconsistencies with other standards should be dealt with. Principles should be tied to a sound conceptual framework. Any departure would have to be explained. It may be necessary to depart from the framework if emerging transactions indicate that the framework is out of date. Any exception to the framework, however, should provide a basis for elimination of the exception by later changes to the framework itself.

The use of principles should eliminate the need for anti-abuse provisions. It is harder to defeat a well crafted principle than a specific rule which financial engineers can by-pass. A principle followed by an example can defeat the 'tell me where it says I can't do this' mentality. If the example is a rule then the financial engineers can soon structure a way round it. For example, if the rule is that, if A, B and C happens, the answer is X, the experts would restructure the transaction so that it involved events B, C and D and would then claim that the transaction was not covered by the standard.

A principle-based standard relies on judgements. Disclosure of the choices made and the rationale for these choices would be essential. If in doubt about how to deal with a particular issue, preparers and auditors should relate back to the core principles. The basis for conclusions (the rationale underlying a particular standard and published with it) should also include, in particular, the question of whether there is only a single view to tackle the economics of the situation. Often there are competing views - is one deemed to be more relevant. If so, reasons for choosing that particular view should be explained in the basis for conclusions and reasons for rejecting the others clearly outlined.

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[4] Source: World Leasing Yearbook 2008

All application guidance and examples to understand the principles have to be questioned. Would anything be missed if they were deleted? If guidance is necessary, is the principle sufficiently clearly stated? Does the standard include bright lines and arbitrary limits? Why are these necessary? Does the transition to the new standard follow the normal pattern? If not, why is a change proposed?

Of course, the viability of a principles-based system depends largely on its implementation by preparers and auditors. Ultimately, the profession will get the standards it deserves. If it does not act with integrity; if in court it attacks reasonable judgements which have turned out to be, with hindsight, incorrect; if it keeps asking for voluminous interpretations or additional guidance; if raw economic facts are unpalatable, if the regulators insist on particular ways of dealing with a situation—a rules-based system is inevitable.

The future for IFRSs

As I mentioned earlier, I am delighted that Canada has agreed to adopt IFRSs and has developed a sound approach in preparation. Of course, the adoption of IFRSs means change. My advice for you is to continue to use the Canadian standard-setter to gather and develop views representative of interested parties in Canada. This necessarily means providing the standard-setter with the necessary resources so that they can participate in the IASB's projects at the earliest stages possible. The Canadian standard-setter plays a key role in our deliberations and has major influence worldwide. We will listen, but when our process is over we hope that you will respect the outcome.

We are at an important stage of the development of IFRSs. We expect nearly 150 countries to adopt IFRSs by 2011. Our convergence programme with the United States should be nearly complete, and we are waiting for the SEC to determine whether US companies will have the option to use IFRSs or whether a firm deadline for US adoption will be set.

In the intervening period and consistently with our MoU work programme, we will be issuing a number of standards in key areas over the coming years. It is likely that the result will be accounting that is more "tell it as it is". The world of "tell it as is" accounting will naturally lead to more volatility in financial results, but the one thing that we know about the world's markets is that they are volatile. With the development of our new financial statement presentation standard and the use of management discussion and analysis, we hope to provide companies the tools to explain their performance in a way that reflects the economics.

We are also conscious that this is a time of rapid change for those countries adopting IFRSs. We will provide those adopting IFRSs at least one year between the publication of a standard and its implementation and will review key elements of standards two years after their implementation.

I strongly believe that we have a once in a lifetime opportunity to create a set of accounting standards appropriate for the world's market that we can be proud of. Despite the progress made to date, the IASB cannot rest on its laurels. The current financial crisis demonstrates that the stakes are too high. The IASB recognises the relevance of its work to

the world's economy and will work expeditiously to achieve its ultimate objective—a single set of high-quality principles-based standards used in the world's capital markets.