

IASB Speech

Mind the Gap (Between non-GAAP and GAAP)

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Speaker: Hans Hoogervorst

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Introduction

Ladies and gentlemen, distinguished colleagues, it is a pleasure to be here once again in Seoul. Let me begin by thanking our hosts, the Korean Accounting Association and the Korean Accounting Standards Board, or KASB.

This is my third visit to Korea on IASB business. I hold particularly fond memories of my first visit to Seoul in 2010, because I was then interviewed by the IFRS Foundation Trustees to become Chairman of the IASB. It is always a pleasure to spend time in this wonderful country, and I will keep coming back for as long as you invite me.

Korea is a regional leader in many areas, and that list now includes financial reporting. Your decision to adopt IFRS from 2011, in full and without modification, demonstrated a strong commitment to global accounting standards. Ever since, Korea has invested heavily in further enhancing its capabilities in accounting standard-setting. The KASB provides excellent input to our work. It is a significant contributor to the work of the Asian Oceanian Standard Setters Group and the IASB's own Emerging Economies Group. Two very good examples of your deep research capabilities are your work on foreign currency transactions and on the equity method of accounting.

In return, we are fully committed to making sure Korea is well represented across our organisation and throughout the life cycle of the standard-setting process. We are honoured to have Duck-Koo Chung serve as an IFRS Foundation Trustee, and to have my colleague and friend Chungwoo Suh on the IASB. Steve Lim serves as a member of the IFRS Advisory Council and we are honoured to have secondees from the KASB and the Korean Financial Supervisory Service on the staff of the IASB in London. I am also pleased to see that Korea has now become a member of the IFRS Monitoring Board.

We have also listened carefully to feedback from Korea's transition to IFRS. It is now four years since that transition took place, and we have studied carefully the recommendations you proposed in your excellent post implementation review of Korean adoption of IFRS.¹ Consistent with these recommendations, we have strengthened the role of the IFRS Interpretations Committee. We have also introduced an Adoption Committee, on which I sit, to better coordinate the resources of the IFRS Foundation in support of adopting jurisdictions.

These are just a few examples of the very strong ties that now exist between the IASB and Korean stakeholders. Your input is very important to us, and I thank you for your continued commitment to our mission of global standards.

I have been asked to speak to you this morning about 'IFRS and its future direction'. I will begin by providing an update on progress towards global standards. Then, I will talk about some of the projects that we are working on. I will focus on our Disclosure project, in particular the use of alternative performance measures, and on our work in the area of digital reporting.

The path towards global standards

First, global standards. The case for a single, high quality language of financial reporting was already very strong when the IASB began its work. However, that case has continued to grow as the world economy has become more closely coupled and tightly integrated. Before IFRS, the accounting for the most basic metrics such as revenue and profit differed significantly, depending on where in the world that company was listed. Investors were easily misled. It was a mess.

Today, the situation has vastly improved. Our latest research has analysed the financial reporting requirements of 138 countries. That research shows that 114 countries now require the use of IFRS for all or most publicly listed companies. 12 more permit its use. For most of these jurisdictions, IFRS is no longer a new development. It's just business as usual.

IFRS is also used extensively in the few remaining major jurisdictions that do not yet require the use of IFRS. In Japan the number of companies voluntarily switching to full IFRS has significantly increased in the recent past. By the end of 2015, more than 100 Japanese companies are expected to have made or announced their transition to IFRS, representing more than 20 per cent of the total market capitalisation. This progress is much faster than anyone had expected.

¹ *IFRS adoption and Implementation in Korea, and the Lessons Learned* (2013), www.iasb.or.kr

China is also a very important member of the IFRS family. The Chinese accounting standards are very close to IFRS and lead to almost identical outcomes. More than 250 companies, equivalent to 30 per cent of the total Chinese market capitalisation, use IFRS for the purpose of their dual listings in Hong Kong. In most cases, the differences between financial reporting under Chinese GAAP and under IFRS of these companies are negligible.

The Indian government has also begun its own convergence programme with IFRS. From 2017, listed Indian companies will be required to report using new Indian Accounting Standards which are much closer to IFRS. We will continue to work closely with our colleagues in India and remain hopeful that Indian standards will end up being fully aligned with IFRS.

In sum, we continue to make good progress towards the objective of truly global accounting standards, especially here in Asia, the most dynamic economic region in the world.

The Disclosure Initiative

Let me now turn to our Disclosure Initiative.

Wherever I go around the world, people complain about the complexity of accounting and about financial statements becoming lengthier and more difficult to understand by the day. So this is an issue we need to look at seriously.

One of the areas in which the IASB is determined to make complexity more manageable is our Disclosure Initiative. Financial disclosures have been ballooning for many years, and many preparers claim that some of the information disclosed provides little in the way of useful information to investors. And although investors do not complain about the amount of information they receive, they do raise concerns about the complexity and understandability of financial statements. Tackling this problem requires co-ordinated action by standard-setters, regulators, companies and auditors. However, I do believe the IASB needs to take the lead.

In June 2013 I launched a 10-point plan to help preparers to do away with boilerplate disclosures that are of limited value to investors and take action to make financial statements more understandable. We are well on our way to delivering on this plan. In December last year, we issued amendments to IAS 1 *Presentation of Financial Statements* that encourages companies to apply professional judgement in determining what information to disclose in their financial statements. For example, the amendments make clear that immaterial information should be actively avoided in the financial statements. We will also give preparers more flexibility in presenting their accounting policies.

In this month's Board Meeting, the IASB discussed a draft-Practice Statement on the application of materiality. We expect to issue an Exposure Draft for public comment in the coming months. When finalised we think it will give preparers very useful guidance on how materiality should be applied.

Our next objective is to identify and develop a set of general principles for disclosure in IFRS. The IASB plans to publish a Discussion Paper on this subject in 2015. If you believe that improvements in disclosures are required, then I ask you to take the time to comment on our proposals. As I said earlier, we all need to work together in order to solve this problem.

Alternative performance measures

In the context of our Disclosure Initiative we are also discussing the issue of alternative performance measures, also known as non-GAAP measures. This is currently the focus of much debate. Many preparers present performance measures such as EBIT and EBITDA. On the face of it, presenting these numbers is not bad. The problem is when they are adjusted to exclude various expense or income items. Examples include "core", "normalised" or "sustainable" earnings numbers. Data aggregators and analysts also adjust numbers reported by entities.

Let me start out by saying that we have no fundamental objections to the use of non-GAAP measures. Because IFRS tries to create comparability across economic sectors, our Standards are necessarily generic in nature. We do not define many line-items or subtotals in the financial statements. So we understand how alternative performance measures can be useful in providing investors with insight into how a company is being run and managed on a day-to-day basis.

At the same time, it is important to remember that non-GAAP measures represent a selective presentation of an entity's financial performance. Often, that selection is not free from bias. As Warren Buffett said last month, "When CEOs tout EBITDA as a valuation guide, wire them up for a polygraph test."² Recently, Standard and Poor's published a very interesting study on the use of non-GAAP measures among FTSE 100 companies. The study shows that in 2012/13 no less than 79 per cent of FTSE 100 companies reported an adjusted operating profit that was higher than the unadjusted operating profit.³

Some costs are routinely left out as being 'exceptional' while others might find these normal costs of doing business. A common example is restructuring costs, which are often left out from adjusted

² 2014 Letter to Shareholders, Berkshire Hathaway (2015), www.berkshirehathaway.com

³ Why inconsistent reporting of exceptional items can cloud underlying profitability at non-financial FTSE100 companies, Standard and Poor's (2014), www.standardandpoors.com/ratingsdirect

operating profit. The problem with these ‘exceptional’ costs is that they keep on recurring. Indeed, restructuring costs are inevitable costs for any business that tries to stay competitive in a changing economy. Standard and Poor’s concludes that ‘Companies that report underlying earnings (or other adjusted profit measure) can often give investors a misleading impression of their performance’.

While the IASB has no ambition to stamp out the use of non-GAAP measures, we do think that investors would benefit from greater discipline in their presentation in the financial statements. That is why the IASB is currently looking at such measures as part of our Disclosure Initiative.

Our starting point for this work is the belief that the IFRS numbers should serve as the primary performance measures by which entities describe their financial position and performance. We go to great lengths to ensure the IFRS numbers are neutral, comparable, and verifiable. IFRS financial statements provide information that markets can trust.

From this starting point, we have no problem with companies providing additional non-GAAP measures to enrich the IFRS data in financial statements. Yet some basic ground rules should be respected. First of all, these measures should not present information that is misleading. As Standard and Poor’s’ study indicates, this is currently often not the case. Also, this information should not be given greater prominence in the financial statements than the IFRS numbers. We have found quite a few examples of financial reporting where the IFRS numbers are overshadowed by non-GAAP measures. In some cases, it’s really difficult to find the net income line.

We have already begun to make improvements in this area.

The Disclosure Initiative Amendments to IAS 1, which were published in December last year, provided guidance to ensure that the subtotals presented in the profit or loss statement or in the statement of financial position are fairly presented. We have also decided to extend this guidance across financial statements and to provide further guidance on the disclosure of non-recurring, unusual or infrequently occurring items in the statement of comprehensive income. Towards the end of this year, we will seek comments on this with the publication of the Principles of Disclosure discussion paper. I urge you to study these proposals and to let us know what you think.

We are also open to the idea of learning from the use of non-GAAP measures. Where the use of such measures is widespread and many companies are systematically adjusting the IFRS numbers, then maybe there is a vacuum in IFRS that we need to look at. It is possible that the IASB will need to define or specify some of the more commonly used performance measures, such as operating profit. This is something that has already happened in your country. Korea has defined operating profit and

requires companies to report it. We are keen to learn from your experience. We are in the process of determining the scope of the Performance Reporting project that will consider this and other related questions. I look forward to working with the KASB, the Korean Financial Supervisory Service and other Korean stakeholders on this very interesting work.

IFRS Taxonomy

This leads me to another area where Korea has shown leadership—the area of digital reporting through your DART⁴ repository for corporate filings. Korea was an early adopter of XBRL and it is very impressive to see that the DART system includes XBRL filings using the IFRS Taxonomy.

As the body responsible for IFRS, our role is to develop a high quality IFRS Taxonomy that jurisdictions such as Korea can incorporate into their own digital reporting activities. The IFRS Taxonomy is critical to us achieving our goal of high quality standards, applied on a globally consistent basis, and, importantly, regardless of format.

We recently made the strategic decision to align the development of the IFRS Taxonomy more closely with our standard-setting activities. As a consequence of this change, digital reporting is considered by the IASB's technical staff throughout the project lifecycle, rather than only at the end as an alternative form of presentation. This also means that Board members are more directly involved in the development of the IFRS Taxonomy and we are encouraging our constituents to do the same.

This approach is already having a positive impact. We recently published an Exposure Draft *Disclosure Initiative* (Proposed amendments to IAS 7) that was accompanied by materials describing the way the proposals in the Exposure Draft would affect the Taxonomy. Comments are due on 17 April 2015.

These changes in due process reflect our commitment to developing the IFRS Taxonomy as a credible and accurate reflection of IFRS disclosure and presentation requirements. We recognise that technology is changing the way in which financial information can be accessed—and we need to respond to that accordingly. Just like our work on alternative performance measures, our work on the IFRS Taxonomy is helping to protect the integrity of IFRS financial information.

Close

Ladies and gentlemen, I thank you for your time and attention. Korea is a strong and trusted member of the global financial reporting community, and your excellent work and commitment to improving

⁴ See <http://englishdart.fss.or.kr>

IFRS for the benefit of all is very much appreciated. I am happy to answer any further questions that you have.