IFRS

IASB Speech

Financial reporting and financial markets

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Introduction

Mr Chairman of EFFAS, Mr Chairman of the Instituto Español de Analistas Financieros, distinguished delegates. It is a great pleasure to be here today in Madrid to celebrate with you the 50th Anniversary of the Instituto Español de Analistas Financieros (IEAF), and to participate in this important conference *Financial Reporting and Financial Markets: New Trends* organised jointly with the European Federation of Financial Analysts Societies (EFFAS) and BBVA. I am honoured to be your keynote speaker, and I will take this opportunity to celebrate with you another important anniversary: it is just 10 years since European listed companies published their first financial statements under IFRS, with the issuance of their first quarterly reports for 2005, thereby applying the EU 2002 Regulation on the adoption of IFRS.

Influenced by the European example, many jurisdictions followed suit. This is a good time to take an inventory of which countries, besides Europe, are making these Standards obligatory, authorised or prohibited.

Let me remind you of the International Accounting Standards Board's (IASB) Mission Statement:

> *"Our mission is to develop International Financial Reporting Standards (IFRS) that bring transparency, accountability and efficiency to financial markets around the world. We serve the public interest by fostering trust and promoting growth and long-term financial stability in the global economy."*

As investing, financing and asset management are becoming global in scope, the achievement of a single, high quality financial reporting language at the global level is more relevant than ever.

On the other hand, as the event today is mostly a European one, and as I am one of the Europeans on the IASB, we can afford to be a little eurocentric in some of our discussions. Hence, it is also a good time to ask the question: did the EU decision bring the benefits that were foreseen in the Regulation on the adoption of IFRS?

Post-implementation reviews are fashionable these days. The European Commission has been asked by the European Parliament to conduct a review of the Regulation and to report back. A report is expected before the summer. No one knows what it will contain, but we can already look at some pieces of information that are available.

Mega-trends in financial reporting

Before I speak about these two topics, let me share with you a few thoughts about the main theme of this conference. What are the mega-trends that are shaping the IASB's technical work and that probably feature prominently on investors' radar screens? I do not claim that I will list all the significant issues, but I will note a few that come to my mind. They are particularly relevant for equity investors. Fixed-income investors certainly have additional concerns with regards to the evolution of monetary policies followed by the US Federal Reserve Board and the European Central Bank.

Globalisation: financial markets are increasingly global, and investing is no longer restricted to safe, well-known, national or regional markets. Investment opportunities abound in emerging economies, growth is stronger in the BRIC countries and financial markets in those economies are booming. But with higher returns come higher risks. We know all too well that accounting scandals are too frequent in some emerging markets. High quality financial reporting is one tool for reducing investment risk. Furthermore, the optimisation of capital allocation is made easier if the financial information is directly comparable.

Currency changes: investing internationally, or investing in entities that are active on foreign markets, means that one takes on an exposure to Forex risks, which can be significant when currency exchange rates are as volatile as they are today. Investors need to better understand the currency risks that affect companies and how they are managed and hedged. Hedge accounting needs to depict accurately those risk reduction activities. The same is true of the volatility in commodities, energy prices and interest rates.

High leverage and asset valuation problems: today's economy is marked by highly leveraged financial strategies, not only in the banking industry. Easy monetary policies and historically low borrowing costs are pushing up asset prices. Multi-billion dollar mergers and acquisitions deals are the norm. Such deals are based on assumptions about underlying asset values, which in turn rely heavily on forecasts—sometimes on dreams—about growth in markets. However, the modern economy is also quite cyclical, and prone to high volatility. Hence, the repeated creation of bubbles and impairments of assets and goodwill are likely to be seen in the periods that follow an investment in excess capacity or a large business combination. The strictness of accounting standards, and the quality of their enforcement, is very important to investors.

Low interest rates: the current environment, characterised by very low or even negative rates on high quality bonds, creates new financial and accounting challenges. The impact on balance sheets of the reduction in discounting rates can be very material and one can ask how it should be reflected in the performance of companies. It also puts the spotlight on the pension obligations of many entities: how can they face up to their defined benefits plans? The same applies to life insurance companies.

Diversification: many entities want to mitigate these risks by engaging in diversified activities or operating in different geographical zones. Their consolidated financial statements give an aggregated view but cannot, by themselves, allow investors to understand in sufficient detail the risks and returns of those different activities and markets. Segment reporting (IFRS 8) is of the utmost importance, as are the recently improved disclosures of key figures for entities that comprise a consolidated group (refer to IFRS 12).

Key performance indicators, non-GAAP figures and disclosure overload: the management of companies wants to communicate to investors the way they see their performance, and investors need quantified information about key performance indicators (KPIs). IFRS currently does not cover this form of financial reporting, and the reliability of published non-GAAP information, which is frequently not audited, is questionable. With our Disclosure Initiative, which I am sure we will discuss at the round tables later today, we want to increase the rigour of non-GAAP reporting and clarify how it connects to the financial statements. We also need to complete our work on Reporting Performance. In addition, we need to work in close co-operation with the competent market authorities to reduce boilerplate information and excessive disclosure of immaterial items, which detract attention from relevant information.

Where are we in terms of global adoption of IFRS?

The EU Regulation of 2002 introducing the application of IFRS contained the following statement:

> *"In order to contribute to a better functioning of the internal market, publicly traded companies must be required to apply a single set of high quality international accounting standards for the preparation of their consolidated financial statements. Furthermore, it is important that the financial reporting standards applied by Community companies participating in financial markets are accepted internationally and are truly global standards.*

This implies an increasing convergence of accounting standards currently used internationally with the ultimate objective of achieving a single set of global accounting standards."

Clearly, from these early days, European authorities have been strong supporters of global standards and of the convergence process. The US Securities and Exchange Commission and the US Congress were also supportive, in the spirit of the post-Enron and Sarbanes-Oxley reforms. The Memorandum of Understanding signed in 2002 between the IASB and the US Financial Accounting Standards Board (FASB), known as the "Norwalk Agreement", gave effect to this policy. After the 2008 financial crisis, the G20 leaders put the achievement of a single set of high quality reporting standards very high in their programme. It is therefore interesting to gauge the extent to which we have achieved this goal of global standards.

130 jurisdictions have now pronounced in favour of IFRS

The IFRS Foundation has been able to analyse 138 jurisdictions[1] (an updated version of the study has just been published). It found that 130 jurisdictions have made a positive pronouncement in favour of IFRS as the sole global accounting standard for financial information, including all the countries represented at the G20. Together, they represent 96 per cent of global GDP. Adoption does not always follow the pronouncement, but even in the major jurisdictions that have not yet adopted them, IFRS are widely used.

114 jurisdictions have adopted IFRS

Complying with their declarations of intent, 114 of these jurisdictions (83 per cent) make IFRS compulsory for all or most of their publicly accountable companies. Modifications to IFRS are rare, but there is a minor degree of diversity among these jurisdictions.

First of all, in the timing—for two jurisdictions, the decision has been taken but is not yet effective (Colombia and Bhutan will switch to IFRS in 2015 and 2021 respectively). The impact on today's global financial markets is probably not very significant.

Second, some jurisdictions apply IFRS, but have adopted previous versions of the standards (Macedonia (2009), Myanmar (2010), Sri Lanka (2011) and Venezuela (2008)). According to the available information, these jurisdictions are working on getting up to date. Again, I would not consider this difference as very significant.

[1] Source: "IFRS as global standards: a pocket guide"—IFRS Foundation, 2015 issue.

Third, some, although only a very few, jurisdictions have made temporary modifications to certain provisions of the Standards. The most notable is the famous European '*carve-out',* which involved slightly modifying IAS 39 *Financial Instruments* at the time of its adoption in Europe, in order to delete certain paragraphs relating to hedge accounting. The application of the carve-out only concerns around 20 banks, out of the 8,000 publicly traded European entities that apply IFRS. Other temporary modifications made by some jurisdictions consisted of deferring the application dates of some Standards. Hence, Europe deferred the mandatory effective date of IFRSs 10, 11 and 12 until 2014. This is now behind us.

12 jurisdictions allow the use of IFRS

12 jurisdictions do not make IFRS obligatory, but authorise their use. Three of them have a significant impact on financial markets; let me give you more details on the situation there.

IFRS is not obligatory in **Switzerland**, but is widely used. In the international market segment, in other words the companies whose securities are likely to be acquired by foreign investors, 84 per cent of the companies apply IFRS, compared with 16 per cent that apply US GAAP. The same does not apply to smaller companies that are not looking for international investors—in this domestic area, the use of national standards is most common (65 per cent), while IFRS is used only by a minority (7 per cent). US GAAP is not used at all and 28 per cent apply banking law. Foreign companies that are publicly traded in Switzerland may also apply IFRS.

In **Japan**, IFRS has been authorised since 2010, subject to certain conditions. In October 2013, the regulator relaxed the conditions for voluntary adoption of IFRS, which resulted in an increase from 600 eligible companies to more than 4,000, accounting for almost all publicly traded companies. Hence, in February 2014, 34 companies had made the decision to use IFRS. As of the end of March, 2015, 75 companies have adopted or are planning to adopt IFRS in Japan. The market capitalisation of these companies accounts for approximately 20 per cent of all listed companies[2]. (Among the most recent adopters are Hitachi and Toshiba, which announced their forthcoming move to IFRS last January.) Furthermore, foreign companies publicly traded in Japan are also authorised to apply IFRS.

At present, **India** permits the application of IFRS, but only 11 companies have made that decision so far. These are essentially companies whose securities are also publicly traded in another country. For other listed and large companies, the national standards began their convergence with IFRS in 2007. Since 2013, the Indian Companies Act requires the publication of consolidated financial statements based on a new set of accounting standards. 35 Indian Accounting standards have already been

[2] Research by the Financial Services Agency in Japan, published in April 2015.

published and correspond more or less to the IFRS that were in effect on 1 April 2011. Their official adoption is expected in the near future and we are also expecting the publication of the roadmap for subsequent convergence.

Four specific cases

Two jurisdictions impose IFRS only on banks (Saudi Arabia and Uzbekistan). However, there is a plan in Saudi Arabia to adopt IFRS for all listed entities from 2017. Thailand and Indonesia are in the process of converging their standards with IFRS.

Eight jurisdictions apply their national rules

(Bolivia, China, Egypt, Guinea-Bissau, Macau, Niger, United States and Vietnam).

In the two largest economies on the planet, China and the United States, political authorities have made a commitment in favour of IFRS but have not (yet?) put it fully into effect. As a result, although the jurisdictions that have made a commitment in favour of IFRS represent 96 per cent of global GDP, the score falls to 58 per cent for jurisdictions that actually apply them. However, there is no suggestion that IFRS is not applied there at all.

In the United States, IFRS is present in two ways. Firstly, there are approximately 500 publicly traded companies that apply IFRS. These are the *Foreign Private Issuers*, the non-US companies that raise capital in the USA (some of which are among the largest corporations in the world: Daimler, Nestlé, Total, Sanofi, etc.). One of the main benefits for these companies of the switch to IFRS has been the end of the obligation to publish a reconciliation between the financial statements issued in their country of origin and the amounts that would have been reported under US GAAP, which was a source of cost and complexity. Since 2007, if the financial statements have been prepared using IFRS (as set by the IASB), they are admissible in the United States without any accounting reconciliation.

Next, the US standards are converging with IFRS standards. From a European perspective, there is a tendency to only see the efforts made by the IASB to achieve convergence with US GAAP, but US GAAP is also converging with IFRS. For example, in 2004, after IASB adopted IFRS 2 on Share-based Payments, the FASB was able to issue its corresponding standard, which had been blocked by the backlash from corporate America. In May 2014, IFRS 15 *Revenue from Contracts with Customers* appeared at the same time as the new US standard on revenue recognition. These two standards are substantially identical.

Although the US has not made a decision to switch to IFRS, work on convergence has continued and the differences between the two bodies of standards are being reduced. You can expect that the upcoming standards on lease contracts will also be substantially identical. Lastly, it should not be forgotten that US investors are major buyers of securities in companies that use IFRS and are therefore major users of IFRS.

In China, the application of IFRS is more ambiguous. Indeed, IFRS is not authorised for companies that are publicly traded in China and foreign companies cannot raise capital there. But the leading market for the trading of Chinese companies remains Hong Kong, where IFRS is authorised. Hence, the largest Chinese companies traded in Hong Kong have made the decision to apply IFRS. Furthermore, some of these companies already applied the Hong Kong standards, which are now exactly the same as IFRS. As a result, the great majority of Chinese companies publicly traded in Hong Kong (84 per cent by volume and 95 per cent by capitalisation) are now using IFRS.

In addition, mainland China has also committed itself to a process of convergence of its accounting standards with IFRS. In 2006, China adopted a 'package' of 'substantially converged' accounting standards and, in 2010, adopted a roadmap for the continuation of convergence. I do not have time to describe the differences between IFRS and Chinese standards, but it is interesting to note that the differences are limited. Furthermore, for a business that is not concerned with those topics, or that chooses not to use the IFRS options prohibited by Chinese GAAP, the application of Chinese and IFRS standards are de facto similar.

Lessons learnt

This study is full of useful lessons._First, it confirms the pre-eminent role of IFRS throughout the world. Not only have the vast majority of jurisdictions made commitments in favour of IFRS, but those that already apply them represent more than one-half of the world's wealth, despite the obvious absence of China and the United States in this statistic. Nevertheless, even in these two jurisdictions, IFRS plays a major role.

IFRS is the accounting standard for more than 52 per cent of the largest companies in the world, according to the Fortune 500 listings. US GAAP is the second largest accounting standard, with 29 per cent of those companies using it.

The other lesson is that while the European Union played a decisive role in the adoption of IFRS and remains a major 'client' with some 8,000 listed companies and a significant influence on our standard-setting process, it is no longer the majority customer—in fact, it represents $17 trillion of aggregated GDP out of a total of $41 trillion for the jurisdictions that now use IFRS (or 41 per cent)…And the dynamics of economic growth in Asia will only reduce this proportion.

Did the EU decision bring about the expected benefits?

15 years ago, when I was in charge of accounting policy matters at the French financial markets authority (COB), I wrote an article[3] in which I discussed the European Commission's proposal "A new accounting strategy for the European Union—Communication of 13 June 2000 to the Council and the Parliament". My conclusion was:

> *"Wearing a pair of new shoes is always aching at the beginning. Adopting the IAS [IFRS] will represent a significant investment, it will disrupt the series of data used; however everyone in the EU will have to follow the same rules and this will bring about benefits that will be hard to measure, but will be real: pan-European comparability of financial reports, allowing a level playing field and a deeper financial market; more transparent financial information, allowing for a healthier economy; increased role of European investors, resulting in better financial autonomy for EU firms; and a new credibility of Europe in the eyes of the USA, thanks to the creation of the pan-European financial market."*

I was already a big fan of mandating the use of International Accounting Standards, which possibly explains why I am standing today in front of you!

Looking again at the statements that introduced the EU Regulation 1606/2002, two of them are relevant to my theme:

> "*This Regulation aims at contributing to the efficient and cost effective functioning of the capital market. The protection of investors and the maintenance of confidence in the financial markets is also an important aspect of the completion of the internal market in this area. This Regulation reinforces the freedom of movement of capital in the internal market and helps to enable Community companies to compete on an equal footing for financial resources available in the Community capital markets, as well as in world capital markets".*

> "*To adopt an international accounting standard for application in the Community, it is necessary firstly that it meets the basic requirement of the [aforementioned] Council Directives, that is to say that its application results in a true and fair view of the financial position and performance of an enterprise — this principle being considered in the light of the said Council Directives without implying a strict conformity with each and every provision of those Directives; secondly that, in accordance with the conclusions of the Council of 17 July 2000, it is conducive to the European public good and lastly that it meets*

[3] Petites Affiches—*Le Quotidien juridique* 25 septembre 2000 Numéro 191

basic criteria as to the quality of information required for financial statements to be useful to users."

This is the focus of the review that is currently being conducted by the European Commission, and also of the report produced in October 2013 by Mr Philippe Maystadt at the request of Mr Michel Barnier, the then Commissioner for Internal Market and Services. In this report, one of the first Recommendations made by Mr Maystadt, under the title "Commitment to global quality standards", says:

> *"We have observed a wide consensus on the commitment to global quality accounting standards. The initial objective that motivated the adoption of IFRS by the European Union does not seem to be challenged in Europe. Moreover, the G20 maintains its support for a single set of global quality rules. The IFRS are the best choice at the moment.*
> *Some regret that the IFRS body of standards is not flawless and particularly that it is incomplete (there are regulatory gaps in certain fields such as the insurance sector), too complex (which could be a listing obstacle for smaller enterprises), favours a view of the balance-sheet over performance, and lacks stability (the existing standards underwent major recasting as a consequence of the convergence project with US GAAP).*
> *However, its global character is unquestionably the most significant. All the stakeholders interviewed acknowledge that it has improved the quality, comparability and reliability of financial information."*

Following this report, the European Commission conducted between August and November last year a public consultation on the impact of International Financial Reporting Standards (IFRS) in the European Union. All citizens and organisations were welcome to give their views on important aspects, such as the conditions all new IFRS should satisfy to become EU law as well as the costs and benefits that are usually associated with IFRS. In particular, the Commission aimed to examine whether the adoption of IFRS improved the efficiency of EU capital markets by increasing the transparency and comparability of financial statements. It received 200 responses, which can be consulted on their website.

Overall, the tone of the responses is very positive:

- 95 per cent of respondents said that the objectives of the Regulation are still relevant and have been reinforced by the increased globalisation of the economy;
- 86 per cent said that the endorsement criteria set forth in the Regulation are still relevant;

- 85 per cent said that adoption of IFRS in Europe has significantly increased the credibility and worldwide adoption of IFRS;
- 86 per cent said that financial statements of listed companies have become more transparent ;
- 87 per cent said that IFRS have created a level-playing field for those companies that use them;
- 71 per cent said that investor protection has improved as a result of IFRS and 67 per cent said that it has increased confidence in financial markets.

In a few areas, however, there is room for improvement:

- Only 60 per cent of respondents believe that the benefits of using IFRS exceed the cost of implementing them (as I said earlier, wearing new shoes always aches at the beginning);
- Only 63 per cent think that using IFRS has facilitated access to capital markets at the EU or world level. (Here, in my opinion we find again this doubt about the benefits for smaller companies.)

The case of smaller firms for which IFRS could be a listing obstacle merits fact-checking. I was pleasantly surprised when I looked two weeks ago at a statistical analysis[4] of the accounting standards chosen by companies listed on ALTERNEXT (an alternative trading platform established in Paris, Brussels, Amsterdam and Lisbon). For the 174 companies listed on ALTERNEXT, IFRS are not required by the EU Regulation but they can be applied voluntarily in lieu of the national standards (provided the company presents consolidated financial statements). 128 of those companies present consolidated accounts and have a choice of standards. 46 (36 per cent) have chosen IFRS and they account for more than half of the total market capitalisation of ALTERNEXT. It is true that the choice of IFRS seems to increase in proportion to the size of the companies, but all of them are really small or medium-size entities. On this basis, the assertion about the obstacle should be taken with a pinch of salt.

I have looked at the EFFAS response to the consultation questionnaire and I noted a few additional remarks that you made to explain your responses.

- "IFRS provide more information, more consistent information and more up-to-date information and in many cases superior information compared to the information disclosed under national GAAPs."

[4] Study published by Paper Audit & Conseil : « Sociétés cotées sur le marché NYSE ALTERNEXT -Référentiels comptables utilisés et capitalisation boursière » 31 mars 2015

- "Comparability increased significantly in our view but we feel that in certain countries and/or certain sectors (local GAAPs) comparability was already sufficient because of e.g. local legislation."
- "Understandability has in our view improved. Nonetheless, due to the increased complexity of the IFRS Standards and the significant amount of information that is given in the notes, financial statements have perhaps become more challenging to understand."

I have no time to comment on those remarks now, but I am sure that Javier de Frutos and Fred Nieto will bring them as discussion points for our two panels on analysts' needs.

Conclusion

I am confident that IFRS has delivered most of the benefits that were expected and that the initial costs of learning and implementing the system, while they have not been capitalised on the balance sheets of companies and investors, would not need to be written off if they had been.

The world has evolved from a multiplicity of accounting standards to a situation where we speak the same accounting language in much of the world. IFRS and US GAAP, which are the two main sets of Standards, have been brought closer to a large extent. They will probably co-exist for some time. Not an ideal outcome, but certainly a big improvement for the investor community.

And the game is going on. As Sir Winston Churchill once said: *"Success is not final, failure is not fatal: it is the courage to continue that counts"*.

Thank you for your attention. Muchas Gracias por su atención.