IASB® Speech

Introductory comments to the European Parliament

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Introduction

Michel Prada and I thank you inviting us to meet with you so early in the New Year. 2016 will be an important year in terms of accounting and it is good to have a timely exchange of opinions with you. In my introductory comments, I will touch upon the upcoming standards on *Leases* Standard, IFRS 9, *Insurance Contracts* and our *Conceptual Framework*. Michel Prada, as Chairman of the Trustees of the IFRS Foundation, will be happy to answer any questions you may have on our governance

IFRS 9

First some words on IFRS 9. The introduction of an expected loss model for credit losses is the most important element of change in the Standard. Most constituents in Europe and around the world see this new model as a big improvement. It will lead to a more timely recognition of inevitable losses and will make it much more difficult for banks to hide problem loans on their balance sheets. At the same time, it does not go overboard by requiring banks to book big up-front losses when no losses have occurred yet. This would discourage banks from making longer-term loans.

IFRS 9 has been assessed as contributing to financial stability, in particular by the ECB and EBA, and in this it responds to the G20 requests. It has also been regarded as positive for investor protection by ESMA.

I am also convinced that the Standard will contribute to economic growth, because banks will be forced to clean up their loans to zombie companies quicker. This should allow credit to flow to more healthy companies with growth opportunities. For all these reasons we think IFRS 9 is consistent with European demands for a safer, more resilient financial system.

Lease accounting

Secondly, I would like to make some comments about our upcoming *Leases* Standard, which we will publish the day after tomorrow.

Currently, listed companies around the world have around 3 trillion euros' worth of leases, especially in sectors such as the airline industry, retail and shipping. Under current accounting requirements, over 85 per cent of these leases are labelled as operating leases and are *not* recorded on the balance sheet.

Clearly, the accounting today does not reflect economic reality. Despite operating leases being off balance sheet, there can be no doubt that they create real liabilities. During the financial crisis, some major retail chains went bankrupt because they were unable to adjust quickly to the new economic reality. They had significant long-term operating lease commitments on their stores, and yet had deceptively lean balance sheets. In fact, their off balance sheet lease liabilities were up to 66 times greater than the debt reported on their balance sheet.

Moreover, the current accounting for leases leads to a lack of comparability. An airline that leases most of its aircraft fleet looks very different from its competitor that bought most of its fleet, even when in reality their financing obligations may be very similar. There is no level playing field between these companies.

These problems will be resolved in the upcoming *Leases* Standard. All leases will be recognised as assets and liabilities by lessees. The accounting will better reflect the underlying economics.

This change is expected to affect roughly half of all listed companies and will not be popular with everyone. Accounting changes are often controversial and can be met with warnings of adverse economic effects and costs of system changes.

The IASB has looked at all these possible risks very carefully and we will publish a detailed effect analysis on the Standard. Our conclusion is that the risks and costs of the new Leases Standard are manageable.

First of all, IFRS 16 will not put the leasing industry out of business. Leases will remain attractive as a flexible source of finance. It will remain appealing to companies to lease assets so that they do not bear the risks of owning them. While the cosmetic accounting benefits of leasing will disappear, the real business benefits of leasing will not change as a result of the new Standard.

We do not deny there will be costs involved in updating systems to implement the new *Leases* Standard, but we have done our best to keep these costs to a minimum. For example, we are not requiring companies to recognise assets and liabilities for short term and small ticket leases. This should be especially beneficial for smaller companies.

In sum, we expect the benefits of the new *Leases* Standard to greatly outweigh its costs. The new visibility of all leases will lead to better informed investment decisions by investors, and to more balanced lease-versus-buy decisions by management. IFRS 16 will lead to improved capital allocation, which should be beneficial for economic growth.

Insurance

Now for some words on insurance. We expect to finish our deliberations soon and to publish a new *Insurance Contracts* Standard around the end of 2016. The importance of this Standard cannot be overestimated. Insurance is an extremely important business with substantial systemic risks. These risks are currently amplified by the current environment of persistently low interest rates.

Today's accounting Standards for the insurance contracts are highly defective. There is no real global standard and there is a wide variety of practices around the world. Some of these standards provide information that is clearly wrong. Quite a few insurers still report at historical cost. That means they calculate their liabilities using interest rates of many years ago. Clearly, this is misleading information in a situation where interest rates are close to zero or even negative.

Our new Standard will be based on current measurement and most insurers agree that this reflects economic reality much better. While there is broad consensus on this general principle, the insurance business is so complex that resolving all the accounting issues has taken us a lot of time.

As a result, it is clear that the effective date of the new *Insurance Contracts* Standard will be later than that of IFRS 9. Because both Standards are very important to the insurance industry and because they are interrelated, we understand this constitutes a problem for the industry.

We have recently exposed a possible solution to this problem, which includes the option of a deferral of IFRS 9 for pure insurance companies. For conglomerates that combine insurance with banking activities, we will make it possible to adjust Profit or Loss for the effects of IFRS 9 through what we have called the overlay approach. We will evaluate the feedback we get on our proposals in the spring and expect to finalise our decisions well before the summer.

Conceptual Framework

In 2016 we also expect to publish a new version of the *Conceptual Framework*, which is the body of overarching principles that guides our standard-setting. Among the many important issues that we raise in the *Conceptual Framework*, two are of particular interest to many European stakeholders, namely Prudence and Stewardship.

It looks likely that we will reintroduce Prudence in our *Conceptual Framework*. We have defined it as the exercise of caution under conditions of uncertainty. We believe this is an important principle that should discourage overstatement of profits and understatement of liabilities.

We will also give a more central place to the concept of Stewardship. We will make clearer that the objective of financial reporting is not only to help market participants estimate future cash flows. Financial reporting should also help them to assess management's stewardship of a company's resources. Holding management to account is a core goal of accounting standards and we will make that clearer in our *Conceptual Framework*.