IASB Speech

Latest developments and future focus

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Introduction

It is a pleasure to be with you here today in this historic city of Berlin. I would like to thank EY for co-hosting this event. I appreciate the opportunity to speak with you about our work.

I will begin by bringing you up to speed on IFRS developments around the world. I will then talk about our work on the completion of the insurance contracts Standard. Last but not least, I want to say a few words about the central theme in our future agenda: Better Communication.

IFRS Standards around the world

Let's begin with a brief update.

In some ways, events here in Germany provided strong motivation for global accounting standards. In 1993, Daimler-Benz became the first German company to seek a listing in New York. At the time, foreign companies listed in the United States were required to reconcile local accounting standards to US GAAP. And when Daimler did so, the 615 million Deutsche Mark profit reported under German GAAP became a 1.8 billion Deutsche Mark loss when reporting using US GAAP. These were the good old days of hidden reserves and earnings management.

But such vast differences in reported performance–and there were of course other cases such as Daimler-Benz–showed that the patchwork of national accounting requirements was no longer suitable for the global capital markets. Something had to be done, so securities regulators around the world began a process that led to the creation of the International Accounting Standards Board back in 2001.

Our mission is to bring accountability, transparency and efficiency to capital markets around the world. Before I move on, I would like to show you a very short video that explains why this is so important.

As stated in the video, in just 15 years, IFRS Standards have become the de facto global language of financial reporting, spoken fluently in pretty much every financial centre in the world. According to our latest research, nearly 120 countries now require the use of IFRS Standards, while a further 12 countries permit its use.

Broken down by region, we see that Europe and South America are both fully on board. In North America, we have Canada and Mexico as full adopters. Of course, the United States has yet to move forward with domestic use of IFRS Standards. However, more than 500 foreign companies listed in the United States report using IFRS, so the issue Daimler-Benz had has now gone away. Pretty much all of the major African economies are also full adopters.

The last couple of years we have also seen a lot of progress in Asia and the Middle East. All but one of the Middle Eastern countries surveyed require the use of IFRS Standards, while in Asia we continue to see good progress towards IFRS Standards across the major Asian economies. Hong Kong, Korea, Malaysia and Singapore are all full adopters, while both China and Indonesia have in the last year reaffirmed their commitment to achieve full convergence with IFRS Standards. India has just adopted new accounting standards which are almost word-for-word IFRS. In Japan, the use of IFRS is voluntary – and exploding. As of today, 141 big Japanese companies representing nearly 30 per cent of Japanese market capitalisation have adopted or plan to adopt IFRS Standards – a tenfold increase in the last five years.

And so, although the IFRS map of the world is not yet complete, we continue to make excellent progress towards the goal of truly global standards.

Insurance contracts accounting

While the world has been busy adopting IFRS Standards, we at the IASB have been working hard to deliver substantial improvements to the quality of the Standards. In doing so, we have worked in close cooperation with the worldwide standard-setting community, such as the DRSC here in Germany. The best ideas from around the world have become the global standard.

We have plugged the big holes that existed in the old set of Standards and introduced important improvements in existing Standards. The major projects on financial instruments, lease accounting and revenue recognition have now been finalised. These projects represent material improvements that will enhance the quality of financial reporting around the world.

Martin Edelmann will talk about these new Standards later in today's programme, so I do not want to get into detail here. All I would like to do is to show you one slide which demonstrates clearly the need for putting all lease obligations on the balance sheet.

The one remaining major project on our agenda is to finish the new accounting Standard for insurance contracts. We finished our deliberations recently and our staff are very busy drafting the Standard. Given the complexity of many insurance contracts, this is no easy task and our staff are carefully testing that the wording is accurate and workable, using input from the industry.

We have been working on the new insurance Standard for many years and its publication will not come a day too soon. Our current insurance Standard, IFRS 4, is a holding standard which has grandfathered an array of highly diverse national accounting standards. As a result, there is little comparability between insurance companies around the world.

We are currently producing an effects analysis of our new insurance contracts Standard which will give concrete examples of this lack of comparability. As an illustration, I will now show you some real life financial results of an insurance company that uses one national GAAP as the subsidiary of a group, while using another GAAP for its statutory financial statements.

(in millions of US$)	GAAP 1	GAAP 2	Difference	
Revenue	9,010	11,244	(2,234)	-25%
Operating income	1,606	748	858	53%
Total equity	10,375	4,567	5,808	56%

As you can see, the same company shows quite astounding differences – between 25 and 60 per cent in revenue, operating income and equity–depending on the accounting language it uses. At least one of these accounting languages must have it wrong. Most likely, however, they are both suffering from a lack of quality.

Moreover, some of the accounting practices used for insurance contracts around the world are at odds with what are considered generally accepted (or should I even say acceptable…) accounting practices for all other sectors of the economy.

Let me give you a couple of examples. Many insurance premiums contain a deposit component because many insurance products combine insurance protection with investment. More than a few insurance companies recognise all deposits they receive as revenue. Can you imagine a bank or an asset management company doing that? Moreover, premium revenue is often recognised on a cash basis, which is at odds with the general principles of revenue recognition.

A comparison with the IFRS treatment of the pension liability is also illustrative. IAS 19 requires current measurement of the pension liability, so that the pension liability is continually updated to account for–amongst other things –changes in interest rates. In large parts of the world, however, insurers do not fully update the insurance liability. Often they use historical interest rates.

Moreover, there is variety in the measurement of the insurance liability. Some insurers use discount rates that are based on the expected return of assets, others use risk-free discount rates; others still use historical rates based on interest rates at the date of inception.

As a result, the devastating impact of the current low-interest-rate environment on long-term obligations is not nearly as visible in the insurance industry as it is in the defined benefit pension schemes of many companies. Clearly, discounting an insurance liability that was incurred 15 years ago at a historical interest rate of 5-6 per cent does not give relevant information in a time when interest rates are close to–or even below–zero.

In some cases, minimum-return guarantees and other complex features are typically reflected in the insurance liability only when they become worth exercising and even then typically only at an amount that does not reflect their true economic value. For a bank, such treatment of complex financial liabilities would be unthinkable.

As a result, there is not only a lack of comparability among insurance companies, but there is also a great lack of comparability between insurance and other parts of the financial industry, such as banks.

To be fair, most insurers are aware of the shortcomings of current accounting rules and many provide investors with supplementary non-GAAP measures, such as embedded value estimates. But while these non-GAAP measures can give useful information, they suffer from the usual problem of lack of rigour and comparability.

The lack of comparability and the often poor quality of current accounting practices in the insurance industry around the world is clearly unacceptable. Investors know it and the insurance industry itself knows it too and I am happy to say the industry is very supportive of us creating a new Standard. Everybody agrees it is urgent that we fix this as soon as possible. That is why the IASB is determined to publish the Standard as soon as we can.

Better communication

Once the insurance project is out of the way, should we conclude that we are done? I know some of our constituents would like us to come to that conclusion, as they have been struggling to keep up with constant change. Yet I believe there are reasons for us to not become complacent. There is still a lot of work to do. But our focus will not be so much on creating more big new Standards as on improving the presentation of the information that we already require.

We recently sought feedback on our future Agenda for the coming years. Soon, we will publish a Feedback Statement that sets out our plans in detail. However, in response to the feedback received, there is one overriding priority we will focus on, and that is 'better communication'.

High quality, IFRS-compliant financial information is 'necessary but not sufficient' for financial reporting to achieve its communications objectives. We must recognise that preparers sometimes experience financial reporting as too much of a compliance exercise. Investors sometimes believe that the financial statements depict performance in an insufficiently clear manner.

Valuable information gets drowned out by 'tick the box' disclosures and voluminous, but poorly organised and presented, financial data. Our Standards are partly to blame for that. The fact is that IFRS Standards prescribe very little in the way of formatting the income statement. We define revenue, we define profit or loss, but we do not define very much in between. The following slide shows that we do not at all prescribe subtotals in the income statement, while investors are often looking for such subtotals to get a better view of the performance of a company.

So companies have considerable freedom in the way they present the components of income that make up profit or loss. As a result, there is little comparability above the bottom line, making it difficult for users to judge performance. The following slide illustrates the lack of comparability in the very commonly used subtotal of 'operating income'.

Partly as a result of IFRS Standards prescribing few subtotals in the income statement, preparers increasingly present alternative performance measures to investors, which is basically adjusted IFRS. This information is easier for users to consume, but it almost always paints a rosier picture than reality and can be highly misleading. In addition, many companies present non-financial information on, for example, sustainability issues. For the investor, it is often difficult to see the woods through the multitude of information trees.

So what will this 'better communication' theme mean in practical terms?

We will not propose to cut back the information provided, nor to dramatically increase it. But we are going to look at how this information is presented, how it is grouped together, and in what form it is made available. The objective is to make sure that companies can better tell their story through the financial statements, in a way that is clear, objective and consistent.

The central building block of this work will be our Primary Financial Statements project. This project will potentially result in a facelift of what is often called the 'face of the financial statements'. Its focus will be to improve the organisation of the statements of financial performance (profit or loss and other comprehensive income), the statement of cash flows and the statement of financial position, also called the balance sheet.

We will be looking at possibilities of defining commonly used subtotals in the income statement, such as operating income and earnings before interest and tax (EBIT). We might look at creating more disciplined manners for companies to present infrequently occurring components of income. Today, companies all too often adjust earnings numbers for the costs of impairments and restructurings, even when these costs recur almost every year. We might also try to find a better way to present some elements of other comprehensive income, which is currently a conundrum for most investors.

Better communication will also be home to a number of current and future projects–all designed to improve the communications effectiveness of financial statements. These include the remaining parts of the Disclosure Initiative project, such as the Materiality Practice Statement and the upcoming Principles of Disclosure document. We also need to do more work on digital reporting, as financial information is increasingly being consumed electronically.

Better communication will be an overarching theme and a source of inspiration for the coming years. It responds to feedback we received through our various consultations, and it will hopefully deliver material improvements to the communications value of financial statements.

Close

I have talked today about the importance of high quality financial reporting, and the significant improvement in comparability, transparency and overall quality that we have seen over the past decade. It is now time for insurance contracts accounting to catch up, and, as I have discussed with you today, our forthcoming Standard will be an important step in this progression.

I thank you all for your continued support and cooperation in the development and application of IFRS Standards, and I look forward to a successful conference over the coming days.

Thank you.