China and IFRS – an opportunity for leadership in global financial reporting

Hans Hoogervorst, Beijing, July 2011

Introduction

I am greatly honoured to address such a prestigious gathering on my first visit to China as the new Chairman of the IASB.

I would like to thank Director General Yang Ming of the Ministry of Finance and her staff at the Accounting Regulatory Department for convening this event. I would also like to thank President Liu, Trustee of the IFRS Foundation as well as my friend and fellow Board member Dr Zhang Wei-Guo for their work supporting of the goals and ambitions of the IFRS Foundation.

The topic of my speech has been chosen deliberately. China has become or is becoming a world leader in so many areas – from manufacturing to academic research. China is rapidly regaining its historic position as one of the largest economies in the world. Because of this when China speaks, the world listens. In accounting, China has made tremendous progress by building an accounting profession and setting in place a process of continuous convergence with IFRS. This is an achievement of which China should be justifiably proud. This development is also welcomed by important international bodies like ESMA, the European securities regulator and the World Bank.

Still, I believe that China's path to becoming a global leader in financial reporting is not fully fulfilled. If China does want to become a global leader in financial reporting, then the IASB stands ready to support this ambition.

The next 12 – 18 months will be very important for the future direction of international financial reporting. The people in this room have a significant stake in the outcome. Now is the time to speak up, to ensure China's voice is heard and acted upon.

Before I come on to this, as a newcomer to the financial reporting community I feel I should provide some perspectives on why the IFRS Foundation Trustees chose me as a successor to Sir David Tweedie, who achieved so much in his ten years as Chairman of the IASB, and why I am genuinely excited to lead the IASB to a second decade of success. I would also like to share with you my analysis of the priorities for the IASB in the coming years.

My background and interest in financial reporting

Let me begin by sharing with you a series of experiences that triggered my interest in financial reporting and ultimately led to my appointment as Chairman of the IASB.

I've actually been involved in financial reporting matters for some time. I previously served as a Dutch Minister of Finance and more recently as Chairman of the Authority for the Financial Markets, the Dutch securities and markets regulator which is comparable to the China Securities Regulatory Commission here in China.

It was during the darkest days of the financial crisis that I gave my first public speech on accounting, stressing the importance of maintaining the highest levels of transparency in financial reporting. While the accounting was not perfect, I felt strongly that some were seeking to use the accounting standards as scapegoats for failures elsewhere in the system. This was much to the annoyance of those, and there were many, who believed the accounting should be neutered in order to protect investors from themselves and to avoid the markets from being spooked.

Perhaps that is why in 2008 the IASB and the FASB invited me to co-Chair the Financial Crisis Advisory Group, a group of international leaders with broad experience of financial markets. It was a great experience. The FCAG was a very diverse group, consisting of both proponents and adversaries of fair value accounting.

We had fierce discussions, but gradually developed a clear consensus and produced a report that was widely appreciated.

That is when my interest in accounting was truly ignited. I discovered that accounting is not boring at all but intellectually challenging. I discovered that in accounting, the power of the argument can bring people together. People can actually convince each other of their opinion (unlike often in politics).

These experiences triggered a personal interest in accounting, but two factors convinced me of the importance of this work to the broader global economy and my desire to lead the IASB as it adapts to become the global accounting standard-setter.

First, that it is hard to overestimate the importance of maintaining public trust in high quality financial reporting. As both a policy maker and a regulator, I have devoted most of my career to the pursuit of the public interest. The primary public interest that we serve is to provide investors and other market participants with financial information to make investment decisions. But the public interest role of accounting standards is deeper than this definition might imply. Sound economies rely on the provision of faithful, reliable financial information to maintain public trust and ensure the flow of capital to fuel growth.

The recent financial crisis provided a real-world example of what can happen when confidence is lost in published financial information.

The crisis was to great extent caused by fatal flaws in economic assumptions, such as credit underwriting standards, the standards of credit rating agencies and widespread gaming of the Basel capital ratios for banks. To a lesser degree, even accounting standards played a part by providing too much room for off-balance sheet financing and avoidance of impairments of shaky assets.

Many of these issues had been building for years, but it was when investors felt they could no longer reply on published financial information that panic ensued and the markets went into free-fall. It showed why high quality accounting standards are a prerequisite to maintaining public trust, without which no economy can properly function. IFRSs provide that trust.

Second, in addition to their public interest role, high quality, international financial reporting standards are a force for economic progress. When a country adopts IFRSs, it is making a public commitment to maintain the highest standards for financial reporting. As a result, for most countries, inward investment flows, the cost of capital is reduced, and the overall prosperity of a country is likely to increase – raising living standards for all. Investors similarly will be more able to diversify their portfolio and benefit from increased comparability. IFRSs support economic growth and establish a high-quality level playing field for globalised markets. Like no other standard, IFRSs link the new growth economies in the East with the more established economies in the West.

For these reasons it is very exciting to be part of this adventure.

While I am not a technical accountant by training, I hope that my experience and contacts outside of the pure financial reporting world can assist the IASB as it takes its rightful place as an important cog in the global financial system. I am fortunate to have a strong Vice-Chairman in Ian Mackintosh, former Chairman of the UK ASB, and together with my fellow IASB members we will share much of the international outreach and technical work.

My priorities

I would now like to turn to what I see as the IASB's priorities for the near future. These priorities are largely determined by the two factors I have already discussed. As an organisation that serves the public interest and promotes economic progress, our main output, financial reporting standards, must be of the highest quality. They must be developed following a robust process that takes into consideration the requirements of those who use them, and must be recognised, understood and accepted internationally.

To me, this translates into four specific priorities;

1. Completing our convergence programme

First, we must complete the remaining convergence projects with the US standard-setter to the highest possible standard, and to do so in a way that benefits from the input that we receive from the entire global financial reporting community. These remaining convergence projects address some of the most difficult and important areas of financial reporting.

Our work to improve international and US revenue recognition requirements is at an advanced stage. After a final re-exposure, the new joint standard will replace US requirements that are generally considered to be too detailed and international requirements that are not detailed enough.

Our project to improve lease accounting requirements –which is also well advanced- will provide investors with better information on the rights and obligations companies have through their lease commitments. This project represents an important step in our work to push back off-balance sheet financing.

Our work to improve and align our respective financial instruments accounting standards is also much needed. This is perhaps the most pressing item on our plate right now. The two boards have already proposed moving to an expected loss impairment model. Last week the boards took important steps to come to a common solution.

The IASB is re-deliberating our proposal on hedge accounting based on public comments we received, and we are midway through developing proposals that address the challenging topic of portfolio hedging.

Although it is not part of the Memorandum of Understanding between the IASB and FASB, completion of the Insurance standard is a very important priority.

It is simply unacceptable that IFRSs only have a stopgap standard for this very important part of the financial industry.

We need to ensure that each of these standards is as good as it possibly can be, that we have listened and understood the various arguments before determining, with clarity, how to proceed. We will not be able to please everyone, which is why the standard-setting process has to be beyond reproach.

2. Consulting on the post-convergence agenda

Second, we will begin to develop the IASB's post-convergence agenda. Within the next few weeks, we will publish a consultation document that sets out some ideas but more importantly is designed to solicit feedback.

You will notice that we deliberately leave many questions open for comment. What is in urgent need of fixing? How should we best deploy the limited resources at our disposal? At the same time, there are some obvious candidates for the future agenda. Everyone is asking us to complete the conceptual framework, and thereby firm up the philosophical and methodological underpinning of our work.

I also think our future agenda should clearly show that we have a lot of new jurisdictions tied to IFRSs, which includes China. These countries have legitimate requests and are waiting for an answer.

Our consultation document mentions several possible projects that are particularly relevant to this region, including business combinations between entities under common control, foreign currency translation and agriculture.

Many of our stakeholders feel that we need to come up with a much firmer underpinning for Other Comprehensive Income and the related issue of 'recycling'. I think this is very important as it relates very closely to the endless discussions around volatility in measures of reported profit and equity.

A major complaint during the financial crisis was that accounting standards led to excessive volatility by relying too much on unreliable market information. These critics feel that accounting standard-setters should serve not only transparency, but also stability.

I have always thought this supposed conflict between stability and transparency to be a false contradiction. In my view, transparency is an essential precondition for stability. The crisis was caused by lack of transparency of risks building up in the system. So the main contribution of accounting standards to stability is by providing transparency.

The IASB is sensitive to the issue of avoiding introducing accounting volatility. At the same time, many of us feel that the methodological underpinning of OCI is not firm enough and that it is too often used as the dumping ground for difficult issues.

If we could come up with a sound definition of OCI and therefore also of the P&L, we will have achieved a major feat. I am not sure if we can completely succeed in putting the debate on stability versus transparency to rest, but of one thing I am sure: accounting should not be the source of volatility, but it should never be used to mask volatility.

3. Delivering global standards

Third, we must do all we can to complete the G20-endorsed transition towards global financial reporting standards. There is an enormous amount of support for a single set of global financial reporting standards, from the G20 leaders down. How do we harness this incredible support and goodwill at the highest levels, to help us achieve our goals? This is one of the most important questions for the IFRS Foundation in the coming years and we will be reaching out to others for their help and support.

An important piece of the IFRS jigsaw is encouraging the United States to come on board. IFRSs are already permitted for use by non-US companies listed on US markets. The SEC has indicated that later this year it will make a decision about incorporating IFRSs into the US financial reporting regime for US companies.

The United States is the largest national capital market in the world, with the most developed and sophisticated national accounting standards.

It therefore seems reasonable to me that the SEC has taken its time to make the appropriate transitional arrangements. At the same time, it is understandable that US companies need certainty in the near future, and a decision this year has been promised.

Let us be clear. This is not an easy choice for the US to make. The rationale for European adoption in 2005 was relatively straightforward. You couldn't have a European common market with 25 ways to account for the same transaction.
The United States already has high quality, mature financial reporting standards. In fact, US expertise has been a very positive influence on the development of IFRSs. So objections regarding the cost of transition and perceived loss of sovereignty must be handled in a sensitive

manner. I think it is only logical that the United States would have a national endorsement protocol for new and amended IFRSs. Other countries do exactly the same.

Difficult as the decision may be, it is hard to imagine the possibility of the United States not taking a positive decision. US investors invest globally and US companies seek international capital, and it is in the economic interest of the US to adopt IFRSs. As a signatory to G20 communiqués, the US has repeatedly expressed its support for global accounting standards.

But the main thing is this: if you believe in a global language for financial reporting, then IFRSs are the only possibility.

I am convinced that the United States will want to maintain its position of leadership in international financial reporting, and therefore it is hard to fathom a negative decision on the part of the SEC.

For other countries that are 'nearly' on board, that are following paths to align national standards with IFRSs but have not yet adopted, our message is equally clear. Come fully on board and help to make this an even more global organisation. The big growth economies should assume the leadership role that their economic strength is calling for.

4. Strengthening institutional relationships

Fourth, we will continue to strengthen the IASB's institutional relationships in a way that respects and enhances the independence of the standard-setting process. By that, I mean to deepen our engagement with those around the world who are impacted by our work, and to ensure that they have a sense of ownership and respect for the product that we are developing for investors globally.

Chinese leadership in financial reporting

Having outlined our priorities, the final topic I would like to discuss today is Chinese leadership in international financial reporting. A topic that is pertinent to all of you in this room.

Since it began its programme of economic reform, China has sought to transition its accounting system from one based on the needs of a planned economy towards international accounting standards based on market economic principles. In 2006, this culminated in the Chinese Ministry of Finance promulgating an entirely new set of new accounting standards principally in line with IFRSs. These new Chinese standards are developed through a process that China calls "continuous convergence" with IFRSs as issued by the IASB. Indeed, while Chinese GAAP is not word-for-word IFRSs, I understand that analysis by the Chinese regulator shows that for companies with dual listings in Shanghai (using Chinese GAAP) and Hong Kong (using IFRSs) the average difference in reported profit is 0.6%. The difference in term of net assets is even as smaller as around 0.2%.

The opportunity for Chinese leadership in financial reporting is significant, and in my opinion, vital. However, I cannot help feeling that China has not received the international recognition it deserves for this herculean effort. Indeed, when broad-brush developments in international financial reporting are discussed, it is the United States, Europe and Japan that seem to be front of mind.

Why is this, when China is the world's second largest national economy and has invested so substantially in high quality financial reporting?

I believe there are three primary reasons.

First, despite evidence to the contrary, there is a lingering suspicion among the broader international financial reporting community about closeness between IFRSs and Chinese accounting standards. In this regard, the term 'principally in line with IFRS' does China no favours. It is for this very reason that Brazil, another country that is on the verge of fulfilling its full economic potential, has decided to fully adopt IFRSs. In its strategy to become the leading regional financial marketplace, Brazil knew it needed the full benefits of the IFRS franchise. Investors in London, New York, Paris, Frankfurt, and Shanghai all understand when a Brazilian company's financial statements are labelled 'in conformity with IFRSs'.

Let me postulate that we respect any decision that China takes vis-à-vis IFRSs. Only China can decide the steps it wants to take to further its interests in accounting standard-setting. But if the remaining differences between Chinese GAAP and IFRSs are as small as I believe they are, why don't we work together to eliminate them? To paraphrase Neil Armstrong, when he first set foot on the Moon; it would be a small step for China, but a huge step for the accounting world. Small technical differences in the standards should not stand in the way of Chinese leadership in international financial reporting.

Working together to eliminate these small differences will eliminate any doubt about China's commitment to high quality financial reporting, and will ensure that Chinese influence in standard-setting matches its economic might.

The way to achieve this is to deepen cooperation between the IASB and the Chinese authorities. This could include the setting out of a roadmap that describes the steps to address these remaining differences. Importantly, this should not be just one direction of travel. The IASB will ensure that Chinese circumstances are given due consideration as part of the forthcoming agenda consultation to be undertaken by the IASB. Such a two way approach, as I understand, was one of the key ideas from Vice Minister Wang Jun, when he started to lead the transformation of traditional Chinese standards towards internationally accepted ones in 2005.

Second, I believe there is insufficient understanding internationally of China's commitment to IFRSs and the IASB's commitment to China. Collectively, we can do more to draw attention to the extensive cooperation that has been in place for a number of years. Wayne Upton, our

Director of International Activities, spends more time in China than in any other country. Chinese interests are well represented on the IASB, the Trustees and our various advisory bodies.

However, more needs to be done.

I will ensure that Chinese interests are given careful consideration in IASB debates, and that China gets the credit it deserves for its commitment to IFRSs. Chinese requirements will form an important input for the forthcoming agenda consultation. In return, we need China to speak up on international accounting matters, in the same way it does on other areas of global economic cooperation and financial regulatory reform.

Third, at a technical level we have not managed to engage sufficiently with Chinese stakeholders as part of our day-to-day standard-setting activities. Using a crude measurement of comment letters received, less than 3% of comment letters received in the last year have come from Chinese stakeholders. More has to be done to encourage Chinese stakeholders to engage in the IASB's standard-setting process, either directly or through the Chinese standard-setter. To address this, we will further increase the amount of outreach the IASB undertakes in China.

The emergence of regional standard-setting groups is also an important development in this regard. The formation of the Asia Oceania Standard-Setters Group, or AOSSG, provides an important vehicle for China and other countries in the region to work together to share experiences and viewpoints when working with the IASB.

China played a leading role in the formation of this group and has been instrumental in strengthening its voice to match the well-coordinated regional voices from elsewhere in the world. I strongly support the work of this group and welcome China's participation in this endeavour.

The conclusion

I am grateful for your attention during my address. The prospect of increasing Chinese buy-in and ownership of IFRSs is an enticing one.

I hope that the four priorities that I have outlined – completing our convergence programme to the highest quality, planning for our post-convergence work programme, addressing the missing pieces of the IFRS jigsaw, and strengthening the IASB's institutional relations, provide the necessary encouragement for you to deepen your involvement in our work.

There is important work to do, to ensure that China receives the international recognition for the substantial work it has already done to embrace IFRSs. The completion of this work is important to ensure that China's influence in international financial reporting matches that of the country as a whole.

Under my Chairmanship, I will do everything I can to make sure this happens.