LSE - Accounting Harmonisation and Global Economic Consequences

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Welcome and introduction

I am delighted to join you this evening to tell you about the work of the International Accounting Standards Board. At the end of my speech, I hope I will have convinced you that developing international accounting standards is of vital interest to the global economy. Our work is important, very challenging and can even be fun!

If you know a bit about my career, you will understand why accounting is challenging to me. I am not a trained accountant. Instead, I read History at the University of Amsterdam before going on to study International Relations at Johns Hopkins University in the United States. After a brief spell working for a US bank, I saw the light and decided to commit myself to serving the public interest. I returned to the Netherlands to enter the world of politics. I became parliamentarian and moved on to become minister at the departments of finance, social affairs, and health. In all these roles I worked with my colleagues to reform the Dutch welfare state. It was a very rewarding period, as we saw the Dutch economy regain its former strength.

After leaving politics, I spent several years as Chairman of the Authority for the Financial Markets, a Dutch financial regulator. The AFM is an across-the-board conduct of business regulator, almost identical to its British counterpart, the Financial Conduct Authority. My job was to make sure that the financial industry was transparent and that it treated its customers fairly. As I assumed my position just after the outbreak of the financial crisis, this was a challenging task and that's putting it very mildly!

The AFM was also responsible for overseeing financial reporting. This was my first exposure to financial reporting and much to my surprise I found it a fascinating area. As the crisis started to unfold, many people in the financial industry started to blame accounting rules for the volatility in the financial system. I found this criticism very suspicious as it was a typical case of blaming the messenger.

I made the mistake of using a couple of speeches to speak out on this topic.

Those speeches came to the attention of the IASB, and I was asked to co-lead an advisory group that advised the IASB and its US counterpart on their joint response to the financial crisis. And a few years later I was asked to become Chairman of the IASB, which I did in July 2011.

The moral of the story? Be careful what you say in speeches!

So, why was I interested in chairing the IASB, when I am not a chartered accountant? Believe me, in the year since I was appointed, I have asked myself that question several times. Especially, when we are mid-way through a five-day Board meeting discussing 8 alternatives to accrete interest on the insurance liability, or some other piece of accounting rocket science!

Joking aside, the fact is that accounting really matters. David Tweedie, my predecessor as Chairman of the IASB, used to say that the job of accounting is to keep capitalism honest.

I couldn't agree more. In our public capital markets, many people are working with other people's money.

The relationship between investor and investee is usually anonymous. This relationship is highly based on trust in economic standards, markets and institutions.

The financial crisis has demonstrated how incredibly weak the checks and balances in the public capital markets can be. The banking system was allowed to get horribly risky and leveraged on the back of implicit and explicit state guarantees. We are living in the biggest credit bubble in history and five years after the outbreak of the crisis a global economic catastrophe is still a very real possibility.

The many excesses in corporate remuneration are also indicative of the poor way investor's interests are represented in public capital markets. Since executive pay is more often than not linked to earnings, corporate management has an enormous interest in accounting rules that allows them to present those earnings in a favourable way. Many breakthroughs in accounting were hard-won victories over vested interests; I will give you a couple of concrete examples later on in my speech.

You will start to understand that even accounting is political and why they asked a former politician to lead the IASB. It takes a thief to catch a thief!

High quality financial information is the lifeblood of market-based economies. If the blood is of poor quality then the body shuts down and the patient dies. It is the same with financial reporting. If investors cannot trust the numbers, then financial markets stop working. For market-based economies, that is really bad news. It is an essential public good for market-based economies.

Financial reporting, market economies and globalisation

I would now like to turn to the relationship between the globalization of the world economy and surge in the use of the standards as produced by the IASB. In the world of financial reporting, the most startling development of the last 10 years has been decisions by most of the world's economies – developed and emerging - to embrace International Financial Reporting Standards, or IFRSs as issued by my organisation, the IASB.

There are many reasons why this has come about, but the main one has been the globally interconnected nature of today's financial markets. Capital no longer respects national borders. Investors seek diversification and investment opportunities on a global basis. Multinational corporations want to maintain one set of books across all of their international activities, while regulators and policymakers want a level playing field for financial reporting.

In such a globalised environment it makes no sense to maintain national accounting standards.

They introduce friction to global financial markets, confuse investors and add unnecessary cost to companies. That is why repeated G20 communiques have supported the work of the IASB and called for a rapid move towards global accounting standards.

The good news is that, in the last 10 years, we have made remarkable progress in this area. From pretty much a standing start in 2001, we now have more than 100 countries using IFRSs, including more than 2/3rds of the G20. Half of all Fortune Global 500 companies now report using IFRS.

To understand the scale of this achievement, just look at Europe. In 2002, the European Union decided to switch to IFRS from 2005. The 25 member states at that time had less than three years to prepare. On 1 January 2005, around 8,000 companies simultaneously switched from more than 20 different national accounting regimes to IFRS. That is a truly remarkable achievement.

Where Europe led, others have followed. Look at an IFRS map of the world and you will see all of South America is now on board, Mexico and Canada in North America, the Caribbean, Australasia, vast swathes of Asia, most of Africa and of course Europe, including non-EU countries such as Russia and Turkey.

The growth economies such as China, Korea and Brazil are very supportive of our work. They see IFRS as an opportunity to secure a seat at the top table of global financial reporting. For example, China provides the secretariat for the IASB's emerging economies group. Recognising the growing economic importance of the Asia-Oceania region, next week we will open our first ever regional office, located in Tokyo.

This is quite remarkable progress in little more than 10 years. In my view, the momentum for IFRS becoming global standards has now become unstoppable.

Of course, we cannot overlook the fact that the United States has yet to decide whether and how to adopt IFRS.

As the world's largest national economy, we would very much like the US to be a fully paid-up member of the IFRS community. The US Securities and Exchange Commission, or SEC has been a long-term supporter of our work. The SEC has already determined that IFRS is of high quality by permitting its use by non-US companies listed on US markets. It is estimated that over 500 companies –many of which are European- are now listed in the United States using IFRS.

The SEC had intended to make a decision on IFRS during 2011, but announced in July that it would postpone this decision. We hope that 2013 will bring better news. For the call of the G20 for a single set of global accounting standards to remain credible, it is important that progress is made soon.

The IASB has also acquired a firm position in the governance of the world economy.

The IASB is a member of the Financial Stability Board and works in close cooperation with other international organisations with responsibility for the global financial system. In this role, we have an opportunity to help shape the global regulatory reform agenda.

Why financial reporting is so controversial

The second question that I want to discuss is why financial reporting can be so controversial. There are several reasons for this. It is fair to say that we do not always help ourselves. Many say that the extensive disclosure requirements of both US GAAP and IFRS need some pruning. Sometimes our standards do not seem to make a lot of sense. Allowing banks that have suffered a ratings downgrade to recognise a gain due to a decrease in value of their own debt is politely described as 'counter-intuitive'. In each of these cases, we have either fixed the problem or are in the process of doing so, but these examples do not help our cause.

In other areas, controversy looms because we are trying to shine a light into some dark corners of the financial system. Some historic examples of this are the expensing of stock options and getting pension liabilities on the balance sheet, while a current example is the battle to bring leases onto the balance sheet.

Some time ago, the IASB and the FASB had the mother of all battles against vested interests to record the granting of stock options as an expense. Up to then, companies could grant these options at seemingly no cost, while these stock options obviously diluted the holdings of existing shareowners. There was a huge lobbying campaign led in part by the technology sector, to keep it that way. But there was one question that this lobby never could answer: if these stock options really cost nothing, why not give them to everybody? Even legendary US investor Warren Buffett waded into the ferocious debate.

Writing in the 1998 Berkshire Hathaway annual report[1], he said:

> "A distressing number of both CEOs and auditors have in recent years bitterly fought FASB's attempts to replace option fiction with truth and virtually none have spoken out in support of FASB. Its opponents even enlisted Congress in the fight, pushing the case that inflated figures were in the national interest."

More than 70 Million dollars was spent[2] lobbying the US Congress and other policymakers that the end of the world was nigh, but on that occasion the standard-setters ultimately won. It was the IASB that led the way, paving the way for the FASB to follow suit.

Almost ten years later and very few people question to logic of recording stock options as an expense. It is simply regarded as good business practice.

[1] Berkshire Hathaway Inc. 1998 Annual Report, www.berkshirehathaway.com

[2] Warren McGregor, Personal Reflections on Ten Years of the IASB, Australian Accounting Review, Sept 2012

The same is true with pensions and other post-employment benefits. Many years ago, companies were able to keep off the balance sheet information related to these liabilities.

As is often the case, what is not measured is not managed. As a result, the management of some companies were able to literally give away the value of the company without shareholders knowing anything about it.

At the time, bringing pensions liabilities on balance sheet was hugely controversial. To some degree, it still is. However, such liabilities are now routinely discussed in the boardroom and with investors. This is especially true as many pension schemes are in trouble, and the company is on the hook if things go wrong.

Today, we have a similar battle with leasing. The vast majority of lease contracts are not recorded on the balance sheet, even though they usually contain a heavy element of financing. For many companies, such as airlines and railway companies, the off-balance sheet financing numbers can be quite substantial.

What's more, the companies providing the financing are more often than not banks or subsidiaries of banks. If this financing were in the form of a loan to purchase an asset, then it would be recorded. Call it a lease and miraculously it does not show up in your books. In my book, if it looks like a duck, swims like a duck, and quacks like a duck, then it probably is a duck. So is the case with debt – leasing or otherwise.

Right now, most analysts take an educated guess on what the real but hidden leverage of leasing is by using the basic information that is disclosed and by applying a rule-of-thumb multiple. It seems odd to expect an analyst to guess the liabilities associated with leases when management already has this information at its fingertips. That is why it is urgent the IASB creates a new standard on leasing and that is exactly what we are doing, in close cooperation with the FASB.

Companies tend to love off-balance sheet financing, as it masks the true extent of their leverage and many of those that make extensive use of leasing for this purpose are not happy.

Furthermore, the leasing industry itself is fighting its own battle. Members of the US congress, heavily lobbied by the industry, are writing letters to our colleagues at the FASB. A recent report in the United States claimed that our joint efforts with the FASB to record leases on balance sheet will lead to 190,000 jobs being lost in the US alone. I seem to remember similar claims being made when the IASB and the FASB required stock options to be expensed.

We should not be surprised by this lobbying. The SEC predicted it would happen. In June 2005, the SEC submitted a report to Congress regarding the use of off-balance sheet arrangements[3]. Arguing for a change in lease accounting, the report said, and I quote:

> "The fact that lease structuring based on the accounting guidance has become so prevalent will likely mean that there will be strong resistance to significant changes to the leasing guidance, both from preparers who have become accustomed to designing leases that achieve various reporting goals, and from other parties that assist those preparers."

These words turned out to be quite prophetic. As the financial crisis was caused by excessive leverage, our efforts to shed light on hidden leverage should be warmly welcomed around the world. The fact is that we are still facing an uphill battle. We will need all of the help we can get, to ensure that we do not get lobbied off course. We need national accounting standard-setters, regulators such as the SEC, investors and others to stand by their beliefs and help us to bring much-needed transparency to this important area. We really need their vocal support to counter what is a well-funded and well-resourced lobbying campaign.

Accounting as an economic science

Thus far, I have told you about the public interest of accounting and the reasons why it tends to be so controversial. The third reason why I think accounting is fun, is the fact that it is intellectually challenging and interesting. Basically, accounting is an economic science.

That means that, just like economics, it is as much of an art as a science (no offence meant). Like other forms of economic science, there is an awful lot of judgement that goes into preparing financial statements. Accounting has the same problems as its sibling Economics: you need maths to exercise it, but you should not count on outcomes with mathematical precision.

For example, accounting has multiple ways of measuring the same asset or liability, depending on the business model according to which it is held. The measurement of intangible assets is fraught with difficulties, such as how to value the brand of an acquired company.

The application of professional judgement is an essential characteristic of financial reporting, but we should also not forget that in many cases, judgement is little more than an educated guess.

[3] Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers, June 2005, www.sec.gov

That is why we intend to devote a lot of time revising our Conceptual Framework. The Conceptual Framework is the theoretical foundation of our standards.

It deals with very basic questions, such as: what is an asset; what is the difference between a liability and equity; how do we measure income? Seemingly very simple questions, but I assure you we can make the answers very difficult!

There is almost universal support for completing revisions to our conceptual framework, and on a timely basis. This framework serves as a point of reference for the IASB's decision-making. Where choices are not clear-cut, the framework serves to encourage the IASB to make decisions that are consistent across the standards. The framework is also an important reference for companies when applying principle-based standards.

We already have a framework that works reasonably well. However, areas such as Measurement are still less than perfect, to put it mildly. It is easy to understand why this is the case. After all, measurement is the most judgmental, difficult and politicised part of accounting. We need to bring more rigor and clarity here, but it will be an extremely arduous task which will require a lot of brainpower and courage.

Whatever the outcome, it is most unlikely to receive universal acclaim. Just imagine a group of the world's leading economists sitting together to create the Conceptual Framework of macro-economics. The only certain outcome would be bitter fights, bruised egos and no Framework! The Nobel Prize for economics would automatically fall to the sole surviving economist. Since accountants are very polite human beings, I am sure that we will manage to keep it civilized, but universal praise we will never get.

Conclusion

Ladies and gentlemen, it has indeed been a pleasure to share my thoughts with you today. To summarise, I do believe that IFRSs will become global standards. I also believe that standard-setters will continue to remain unpopular, because change is rarely popular – even if it is change for the better. There are just too many people that profit from status quo.

Thank you for your time. Given that this is the London School of Economics, I look forward to some very challenging questions. Please do not disappoint me!