Europe and the path towards global accounting standards

Hans Hoogervorst, 2013 Ernst & Young IFRS Congress, Berlin

9 September 2013

Sehr geehrte Damen und Herren,

Ich bin *kein* Berliner, aber ich moechte doch am Anfang meines Vortrags einige Worte auf Deutsch sagen. Es ist immer eine Freude nach Berlin zu kommen and ich moechte mich erst einmal rechtherzlich bei Ernst & Young fuer die Einladung bedanken.

Als Europa's groesste Volkswirtschaft, ist Deutschland ein wichtiger Partner in der Zusammenarbeit mit dem IASB. Wie ich spaeter drauf eingehen werde, hat das IASB eine sehr wichtige and arbeitsreiche Phase vor sich. Deutschland's Sichtweise spielt dabei eine wichtige Rolle. Ich bin heute nicht nur gekommen, um ueber das IASB und seine Arbeit zu sprechen, sondern auch um zuzuhoeren and ich bin dabei sehr auf ihre Meinung gespannt.

Being here in the very heart of Europe, I would like to take this opportunity to begin my speech with some general observations on the relationship between the European Union, the IASB and IFRS.

As you may know, EU Commissioner Michel Barnier has asked Philippe Maystadt, former President of the European Investment Bank, to develop proposals to reinforce the EU's contribution to IFRSs. We are grateful to Mr Maystadt for having had the opportunity to contribute to his research and we look forward to the publication of his final report later this year.

Obviously, it is up to the European Union how to organise itself and I do not wish to speculate in any way on the final recommendations that Mr Maystadt will produce. Instead, I will limit myself to pointing out some important facts that govern the relationship between Europe and the IASB.

First of all, it is no exaggeration to say that the success story of IFRS is a success story for the European Union. Europe's decision to adopt IFRS from 2005 gave IFRS the credibility and critical mass it needed to become the single set of global accounting standards. It was a decisive factor for many jurisdictions in their decision to adopt IFRS or to start a convergence process. Currently, over 100 jurisdictions around the world require or permit the use of IFRS. Without the leadership of the European Union, it is doubtful whether this would have happened.

Equally, there can be little doubt that the replacement of Europe's myriad of accounting languages by IFRS was highly beneficial to the European capital market. It is important not to forget that Europe adopted IFRS in part to overcome more than 20 years of difficulties in achieving a high quality set of European accounting standards.

The introduction of IFRS not only provided Europe with an off-the-shelf solution to this problem, but also greatly increased transparency and led to a lowering of the cost of capital for listed companies. The adoption of IFRS has also proved a tremendous boost to improved enforcement in the European capital markets. The introduction of a common accounting language has greatly increased the capacity of ESMA to identify enforcement issues across Europe.

Europe has adopted almost all of our standards lock, stock and barrel. The one exception—the carve-out of IAS 39—is only used by around 20 out of more than 9000 European companies.

Does this near-complete adoption of IFRSs mean that Europe has relinquished its sovereignty in accounting to the IASB, as some seem to think? That is certainly not the impression if you are sitting in our office in 30 Cannon Street.

The EU has retained the prerogative to adopt IFRSs Standard-by-Standard and it takes its endorsement procedures very seriously. In fact, it can be argued that Europe has by far the most stringent endorsement process of all jurisdictions that have adopted IFRS. A myriad of European organisations are involved in the adoption of IFRS: EFRAG, national standard-setters, the Accounting Regulatory Committee, the European Commission, the EU member states and finally the European Parliament.

Many jurisdictions have much lighter adoption procedures. As you may know, we have recently published the first batch of country profiles, which detail how jurisdictions are adopting our standards. Our research shows that more than 40 per cent of these jurisdictions adopt IFRSs *automatically* as they are issued by the IASB, without any endorsement procedure. Most of the others have relatively light endorsement procedures that only involve professional accounting bodies and/or securities regulators. Apart from the EU, only in New Zealand and Australia do parliaments play a role in endorsing IFRS.

It is also important to note that the European Union is not the exception in adopting IFRS without making significant adaptations. Our country profiles show that most jurisdictions do the same. This should not come as a surprise. After all, the G20 has repeatedly stressed the goal of a single set of global accounting standards. If every jurisdiction were to make local adaptations of IFRS, this goal would never be reached.

It is true that some big economies have not yet fully adopted IFRS. However, most of them have made a great deal of progress towards IFRS adoption and progress continues to be made, often behind the scenes. In Japan, for example, in the near future a sizeable number of companies representing around 20 per cent of the total market capitalisation of the Tokyo Stock Exchange is expected to be using IFRS. Although the American SEC still has to make up its mind about the use of IFRS for domestic firms, it is important to note that over 450 foreign issuers, representing trillions of dollars in market capitalisation, are using IFRS in the domestic markets. This makes the US a very significant stakeholder in IFRS.

Finally, the European Union plays a very proactive role in the standard-setting process of the IASB. In fact, there is probably no other jurisdiction in the world that devotes so many resources to outreach, fieldwork and input to the standard-setting process as the EU does, through EFRAG and national accounting standard-setters such as the DRSC here in Germany.

This effort does not go unrewarded. EFRAG itself has pointed out many instances in which it was able to make a positive impact on the standard-setting by the IASB. This proactive role by Europe will be further enhanced by the strong voice of Europeans in the recently created Accounting Standards Advisory Forum.

Finally, I can assure you that in other parts of the world, the EU is not perceived as having little influence in the standard-setting process. Indeed, some of our many constituents around the world are sometimes worried that the EU through its sheer size has too much influence.

I believe that the relationship between the European Union, the IASB and its Standards is overall well balanced and constructive.

We will welcome any proposals that enable Europe to deepen its co-operation with the IASB in pursuit of our shared objective of global accounting standards.

So what of the Standards themselves? How is our current programme of work progressing? Later today, Martin Edelmann, our German Board Member, will lead you through the details of our financial instruments Standards. Let me give you a broader sketch of our major projects this morning.

Convergence

In the last few months we have taken several major steps towards completing the remaining convergence projects.

First of all, we expect to release a new Standard on Revenue Recognition this autumn. We are still tackling some challenges with drafting, but we are confident we will get it done soon. We have taken our time because this is a very important Standard;

it is about the top line and will affect all companies. It replaces American standards that contain thousands of pages of application guidance and IFRS Standards that provide too little guidance. That is why I call it the jewel in the crown of convergence with the FASB.

Lease accounting

Second is lease accounting, another difficult but very important area. Currently, the vast majority of lease contracts are not recorded on the balance sheet, despite the fact that 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. It has been estimated that the hidden leverage in leases leads to an underestimation of long-term debt by some 20 per cent. So we are not talking about small fry.

What's more, the companies providing the lease 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 it simply does not show up in the 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 hidden leverage of leasing is. Some underestimate and some exaggerate the true level of leverage implicit in the leases.

That is why the vast majority of users have told us time and again that they need our leasing Standard to provide rigour and comparability.

We are aware that this change will not be without cost to preparers. We have made some pragmatic decisions to keep costs to a minimum, such as the exclusion of short-term leases and variable lease payments. In addition, much of the information is already required in the notes under IAS 17. Companies that are in full control of their leasing commitments should have most of the information at their fingertips.

I am also convinced that bringing leases to the balance sheet will have benefits to preparers themselves.

I would not be surprised if many CEOs are only vaguely aware of the full extent of the hidden debt in their leasing contracts. By making this hidden debt clearly visible, companies might be able to make more rational decisions on capital allocation. Leasing will certainly not disappear. But companies will be able to make better-reasoned decisions between purchasing and leasing.

Impairment

On impairment, the IASB and the FASB have found it more difficult to stay converged. The fact is that both boards have struggled with impairment. In the past three years, the two boards have developed between us no fewer than six different models and we have still not finished.

We both agree that the current incurred loss models gives too much leeway for banks to postpone the recognition of inevitable loan losses for too long. It is a question of too little, too late. We therefore agree that the incurred loss model needs to be replaced by an expected loss model that is more forward-looking.

However we have found it difficult to agree on the mechanics of the expected loss model. The FASB want all possible loan losses to be recognised on Day 1; we think the bulk of the losses can only be identified and recognised once a significant increase in credit risk has taken place.

One reason why we find it difficult to come to a common answer is that an expected loss model inherently has a relatively high degree of subjectivity, because it deals with uncertain outcomes in the future. There is no straightforward answer on how this can be done.

The good news is that the IASB eventually received very broad support for our latest model and we are certain we can bring it to a conclusion. At the same time, we still hope that the IASB and the FASB will be able to bring their respective models closer together. In September, we will have another joint meeting in London and we will see how far we can get.

Insurance contracts

The fourth area I want to discuss is insurance contract accounting. The insurance industry is a hugely complex and important one, with a collective investment measured in the trillions. There can be no doubt about the systemic importance of the insurance industry.

Because of this, it is unacceptable that we do not yet have a proper Standard to account for insurance contracts. As a result, there is huge diversity and complexity in how insurance companies report their numbers around the world. Investors talk about insurance accounting being a ‘black box’.

Many insurance companies rely on outdated assumptions when measuring their liabilities. Indeed, some use interest rates from many years ago, while we know that the current low-interest environment makes life very difficult for the industry.

EIOPA, the European Insurance regulator, recently raised the alarm bell about the effects of persistent low interest rates on the industry. EIOPA is concerned that some insurance companies will not be able to meet their capital requirements. EIOPA refers to Japan, where persistent low interest rates caused some insurers to fail, while others had to lower the returns they had promised to their customers.[1]

If the insurance industry is a victim of the crisis, it has been a rather silent victim thus far. Part of the reason why it has not made more headlines is that the problems cannot be fully seen, for lack of a proper accounting Standard.

Fortunately, the end to this unacceptable situation is in sight. Recently, we released our second and final Exposure Draft for a new insurance Standard. In our proposals, we require measurement of liability using current interest rates. This will allow investors to gain a much more realistic view on the true performance of the industry. Markets will gain much more insight into how effective insurers are in matching their liabilities with assets. Where our proposals lead to more volatility, it is probably a reflection of real economic risks.

At the same time, we have worked very hard to ensure that the new Standard minimises, to the extent possible, non-economic, accounting-related volatility. Our revised proposals go a long way towards addressing concerns in this respect about our first Exposure Draft. We do acknowledge, however, that there has been a trade-off of increased complexity. We think that we have got the balance about right, but we are keen to hear views before moving to finalise the Standard during 2014.

Future agenda

In July, we published for public comment a Discussion Paper on the Conceptual Framework. We decided to discipline ourselves both in terms of time and scope. Thus far, we have been able to meet our deadlines even though they were very ambitious. Despite these tight deadlines, I think we were able to produce a Discussion Paper that is both readable and thought-provoking. I trust it will serve as a solid basis for a profound public debate.

The Discussion Paper sets out our preliminary views on some fundamental accounting topics, such as measurement and the use of Other Comprehensive Income.

It makes clear we continue to see Profit or Loss as a key indicator of financial performance and that we do not focus solely on the balance sheet. I also think the Discussion Paper gives the beginning of an answer to the question of the significance of OCI, and how its use could be disciplined. We do not pretend that this Discussion Paper will give a definitive answer to all accounting problems. Even if we took ten years and a thousand pages this could not be done.

A topic that is related to the Conceptual Framework is our work to improve financial reporting disclosures. For many companies, the size of their annual report is ballooning. The amount of useful information contained within those disclosures has not necessarily been increasing at the same rate.

Many agree that the disclosure problem is in many ways a behavioural problem. For example, many preparers will throw just about everything into the disclosures to avoid problems with the regulators. After all, no CFO has ever been sacked for producing voluminous disclosures, while restatements may be career-limiting.

[1]EIPOA: Supervisory Response to a Prolonged Low Interest Rate Environment, 28 February 2013

Moreover, excessive disclosures can even be very handy for burying unpleasant, yet very relevant information!

And sometimes it's just easier to follow a checklist, rather than put in the effort to make the information more helpful and understandable.

In summary, understandable risk-aversion on the part of preparers, auditors and regulators leads to a ticking-the-box mentality. The communicative value of financial statements suffers as a result. So what can we do to change this culture? What can we do to break the boilerplate?

Well, first of all, we decided to give a good example ourselves. We managed to reduce the size of our 2012 Annual Report and the accompanying disclosures by 25 per cent compared to the previous year. At the same time, we actually increased the amount of useful information in the report and made it easier to read. It took some intensive discussions internally and with our auditors; but I assure you, it can be done!

Recently, I presented a 10-point plan to deliver tangible improvements to disclosures in financial reporting. Many of them are simple, such as making it clearer that when information is immaterial it is better to avoid giving it, even in the notes.

We also want to give entities more freedom to give a more prominent place to important disclosures or accounting policies.

With these simple measures, we hope to take away all excuses for taking the easy rout of just publishing boilerplate disclosures. I really think this can help companies to communicate more effectively about their strategy. They will certainly help to ignite the much-needed change in mindset of preparers, auditors and regulators that is so sorely needed. The IASB will continue to engage with these constituents and also, very importantly, with users, to facilitate the joint effort that is needed to make disclosures less indiscriminate and more meaningful.

Ladies and gentlemen, I will now draw to a close.

The global financial crisis provided a stark reminder of the interdependence of capital markets and the need for a globally consistent language of financial reporting. This is a responsibility that we at the IASB take very seriously. We are immensely grateful for Europe's continued support for our work, and your commitment to us is fully reciprocated.

I wish you a successful conference and thank you all for your time.