THE IMPORTANCE AND CHALLENGES OF ESTABLISHING STANDARDS FOR GLOBAL FINANCE

Ian Mackintosh, Vice-Chairman of the IASB, at the Manchester Business School, 7 May 2014

Introduction

Ladies and gentlemen, it is a pleasure to be with you this morning. Let me begin with the obligatory disclaimer, that these are my personal thoughts, which may or may not be consistent with those of the IASB and my fellow Board members.

This morning, I would like to discuss with you the importance of global standardisation in financial reporting, a goal shared by almost every country in the world, and by pretty much every international institution responsible for the global financial system, as well as by the participants who operate within those markets—namely those who are seeking capital and those who provide it. I will update you on the remarkable progress that has been made towards the goal of global standards since the formation of the IASB back in 2001. I will also discuss with you some of the challenges that we face, despite the widespread support for our work and our mission.

Global capital markets

In the days when I was a student, capital formation largely happened at a national level. Companies seeking to raise capital did so mainly from providers within their own jurisdiction—banks, private investors and the stock market within that country. Both the provider and acquirer of capital sat within the same country and so both were entirely familiar with the basis on which the financial accounts were prepared.

Today, the business world is very different. A combination of the removal of restrictive trade barriers, the liberalisation of financial markets, advances in technology and the opening up of emerging and developing economies have all contributed to a very different business environment. Today, global competition is the norm, capital markets are globally interconnected and investors scour the world in search of investment opportunities.

National barriers to capital market participants have been swept away. Cross-border transactions now happen not in the blink of an eye, but, with high frequency trading, in quite literally 1/100th of the time it takes to blink an eye.

This shift has been dramatic and far-reaching. It has happened incredibly fast, over a single generation. This dynamic is also self-reinforcing because fewer borders equate to more opportunities for investors, companies and countries.

This transition from national to international capital formation presents huge challenges to policymakers. The recent global financial crisis provided a graphic illustration of how national or even regional approaches are no longer sufficient in managing globally interconnected capital markets.

A global economy requires internationally accepted standards

This globalisation in capital formation has served as the genesis for the move towards globalisation in standards for financial reporting. If investor and investee are increasingly likely to be sitting on different sides of the world, it makes no sense for each and every country to maintain its own different set of accounting standards.

Dealing with multiple reporting requirements adds cost to multinational companies with international subsidiaries. It also impedes the work of the regulatory community, who require a globally consistent measurement of financial performance on which to base other regulatory initiatives.

National differences in financial reporting impede the efficient allocation of capital by adding unnecessary risk and cost to investors. Let me give you an example. Let's say that after graduating you decide to work as a financial analyst for an investment house. Your job is to spot undervalued shares of the leading companies operating in the automotive sector. Like most sectors these days, the peers of the global car companies are international. Ford competes not only with General Motors but also with Toyota, Hyundai, BMW, Jaguar, Geely, Renault and many others.

To spot that undervalued company, you will have to analyse financial statements of companies listed in China, France, Germany, India, Japan, Korea, the United States and the United Kingdom.

Now that's challenging enough, but to further complicate your job, if each jurisdiction uses a different set of accounting standards, the basis for coming up with even the most well understood of numbers such as revenue or net profit can be very different.

A famous example of this from the automotive sector occurred back in 1993 when Daimler-Benz switched from German accounting principles to US GAAP in order to become the first German company with a secondary listing in New York. A profit of around 600 million Deutschmarks that had been recorded using German GAAP turned into a loss of almost 2 billion Deutschmarks when reporting using US GAAP. If you're a financial analyst, that's really going to mess with your evaluation.

This helps to explain why the G20 Leaders, and indeed pretty much every international organisation with responsibility for the global financial system have supported the work of the IASB and expressed their repeated support for global accounting standards.

Progress towards global accounting standards

The good news is that we have seen remarkable progress towards the goal of a global language for financial reporting. Shortly after the formation of the IASB back in 2001, the European Union, Australia, New Zealand, Hong Kong and South Africa led the way with landmark decisions to transition from national accounting standards to International Financial Reporting Standards, or IFRS, at the beginning of 2005. That first wave of IFRS adopters was followed by a second wave of countries transitioning to IFRS, including Brazil, Canada, Korea, Mexico, Russia and Taiwan.

As of today, more than 100 countries require the use of IFRS for all or most listed companies, while most of the remaining countries permit the use of IFRS in some shape or form. Almost every country in the world has made a public commitment to global accounting standards and almost all have stated a view that IFRS adoption is the best way to achieve that commitment. We know this to be true, because we recently completed a major piece of research looking into the use of IFRS around the world. That data has been crosschecked and validated by the relevant authorities around the world and so has an extremely high degree of veracity.

The use of IFRS is extensive even among the few countries that have yet to endorse our Standards. In the United States, for example, US investors are prolific users of IFRS-compliant financial statements, while the SEC allows international companies listed in US markets to report using IFRS. So far, more than 450 such companies have already taken the opportunity to do so. Japan has chosen to allow a market-driven approach to the use of IFRS. The Japanese authorities recently allowed most publicly listed companies to voluntarily adopt IFRS if they chose to do so. So many companies have taken up that option that it is expected that companies representing around 20 per cent of the market capitalisation of the Tokyo Stock Exchange will be reporting using IFRS by the end of next year.

Although it would be tempting for the IASB to claim credit for the spread of IFRS, in reality this has occurred because policymakers in countries recognise the compelling need to move to standardise on a globally consistent language for financial reporting. One standard, applied on a globally consistent basis. Some have said that a competitive or decentralised method of global standard setting would be better. Nations or regions would set standards and various jurisdictions would adopt the best of them. The problem with this is that it would take away the consistency and comparability that one set of global standards offers.

Our role in this process is to ensure that IFRS as global standards meets the needs of our stakeholders. Our Standards must be of the highest quality, developed through an inclusive and transparent due process. We need to work in close cooperation with others to encourage application of those Standards on a globally consistent basis.

The challenges of global accounting standards

So, thus far I have set out the rationale for global accounting standards, I have highlighted the strong support for our work and I have described the remarkable progress that has been made towards establishing IFRS as the single set of global accounting standards.

However, anyone who reads the business pages will know that despite the overwhelming support for our mission, this can be controversial and challenging work for all concerned. The reasons why are best described by three S's.

Sovereignty in accounting standard-setting

The first 'S' is sovereignty in accounting standards. Obvious as it may seem, if you want the benefits of global accounting standards then you need to accept the cost, which is for each country to agree to stick to the internationally agreed standard and to resist the temptation to tinker with the standards.

I can understand why this can be difficult for some to accept, particularly elected officials who are used to determining rules at a jurisdictional level. Some also argue that adopting verbatim the standards of an international body cuts across the notion of sovereignty.

We are not blind to such concerns. There are various safeguards in place to ensure that the IASB is not simply passing down diktats from an ivory tower. Many, but not all jurisdictions have in place endorsement mechanisms to act as a form of sovereignty 'circuit-breaker'. The existence of this mechanism avoids a situation where IFRS developed by the IASB are automatically written into jurisdictional law. Some of these endorsement mechanisms, such as the one in Europe, involve multiple steps and evaluations to assess whether the adoption of that particular new IFRS is in the interests the jurisdiction.

At the same time, market pressure to conform to international norms should ensure that the circuit-breaker is rarely tripped. Indeed, there has only ever been one situation in which Europe chose not to endorse in its entirety a Standard issued by the IASB, and that situation will hopefully be resolved in our work to develop a new IFRS dealing with macro hedge accounting.

We have also invested heavily in sophisticated outreach and stakeholder engagement programmes that seek to ensure the views of all constituents across all parts of the world are heard as part of our standard-setting process and there are high levels of international diversity at all levels of the organisation. For example, we have almost 30 different nationalities among our technical staff, while the membership of our various advisory bodies is also highly international.

Moreover, during 2013 we have taken further steps to emphasise the multilateral nature of the standard-setting process. Central to this is the creation of an Accounting Standards Advisory Forum, or ASAF, to bring in closer to our work national and regional bodies with responsibility for accounting standard-setting within those jurisdictions.

None of this disguises the fact that if you want global standards then each jurisdiction must resist the quite natural temptation to tinker. However, the various mechanisms in place help to mitigate the desire to do so. A failure to adopt a global standard, or a decision to amend or add to that global standard means it simply isn't a global standard any more.

Structure

The second 'S' relates to the unusual structure of the IASB. The fact is that we are a private-sector body that acts in the public interest; and we are an independent body whose Standards are written into law in more than 100 countries. I can fully understand why our organisational structure can seem unfamiliar to many.

There are various reasons why the IASB's structure was chosen back in 2001.

It is useful to draw upon a model to better understand the institutional choices available when designing the structure of international organisations. According to US academic Francis Fukuyama, the perennial problem for international organisations is balancing the competing challenges of efficiency and legitimacy. At one end of the continuum, he sees organisations such as the United Nations, with high levels of legitimacy but lower levels of efficiency. At the other end of the continuum, he describes organisations such as the international ratings agencies that have higher levels of efficiency but low levels of legitimacy in terms of representation or public oversight. In between, he sees literally thousands of international organisations, each with their own view on the correct balance between legitimacy and efficiency.

The challenge is where the IASB should sit on this continuum.

Our private-sector status was chosen because our Standards are used primarily (but not exclusively) by the private sector. Investors investing in companies listed on regulated capital markets rely on our Standards to provide the required levels of transparency and comparability to permit the most efficient allocation of capital. For that to happen, the Standards need to be extremely robust and to be capable of being implemented on a globally consistent basis, if they are to result in the provision of high quality information and if they are to help prevent market abuse.

International bodies composed of public representatives do not automatically always have a good track record of producing international standards with that level of rigour. The presentation of national positions for bargaining and the consensus-driven nature of their decision-making will often result in standards that represent the lowest common denominator of international agreement or that provide substantial latitude to jurisdictions in how those standards are implemented.

Neither of these are characteristics of a high quality, international accounting standard. That is why the IASB was created as a private-sector body with an independent Board of 16 geographically and professionally diverse experts, with decision-making by super majority. Our primary objective is to achieve accounting standards of the highest quality that are capable of being applied on a globally consistent basis.

At the same time, we recognise the public interest nature of our work and the need for public accountability for a private-sector organisation whose role is central to the efficient working of the global financial system. International bodies such as the Basel Committee on Banking Supervision derive much of their legitimacy from their membership. Members serve as representatives of the relevant central bank or other public authority.

For the IASB, its Members serve as independent experts. As a private-sector body, every aspect of our decision-making must be completely open and transparent, while our consultation activities need to be highly inclusive. Every board meeting of the IASB, every meeting paper and every meeting of our Interpretations Committee and Advisory Council is open to the public, webcast and published on our website and kept there for ever. We hold public consultations about whether to begin a project, we consult throughout the development of that project, and we consult at the end of the project after the Standard has come into effect. This is a very different approach to decision-making by other international bodies, much of which happens behind closed doors, but it is essential for us as a private-sector body acting in the public interest.

As Board members, we are appointed by a group of 22 Trustees from around the world, who are in turn appointed by a Monitoring Board of authorities with responsibility for public capital markets. The Monitoring Board is a very high level body. For example, its membership includes Mary Jo White, Chairman of the SEC and Michel Barnier, Internal Markets Commissioner of the European Commission.

This hybrid institutional structure—an independent IASB, oversight by Trustees and public accountability through the Monitoring Board, will continue to be a delicate balance. However, I do believe that it gets the balance about right between legitimacy and efficiency. Indeed, some academics believe that this model has utility in many other areas of establishing standards for global finance.

Standardisation

The third 'S' relates to the challenge of international standardisation. That challenge is to achieve a single, globally consistent way to describe financial performance and an entity's financial position.

Any form of globalisation can be controversial. Although a single, global language of financial reporting is widely supported, the controversy comes in determining what that single, global approach should be. This is significantly complicated by the multitude of different cultural preferences, business practices and accounting traditions that exist in different parts of the world, across the spectrum of developed and emerging economies.

For example, while capital markets may be globally interconnected, historic business practices in different parts of the world have varied. In the United States, companies have traditionally raised funds through Initial Public Offerings. German businesses, meanwhile, were often funded through family or other organic networks while their old accounting standards were heavily orientated towards tax reporting. Japanese companies customarily engage in cross-holdings, whereby they have equity stakes in their suppliers and associates. In centrally planned economies such as China, the State is closely related to most if not all larger companies.

These different business practices have led in many cases to different historical preferences in accounting standards. Standardising on a single, globally consistent approach often involves the introduction of new methods of accounting that are different to those that existed beforehand. It is often difficult for a nation or region to change its traditional practices for the sake of international standardisation.

In other cases, the process of trying to balance competing viewpoints can lead to some being disgruntled with the outcome.

One example of how we have had to balance local interests with our global remit is the debate over the 2010 decision to eliminate the word 'prudence' from the *Conceptual Framework*. Those who want to bring it back include some, but certainly not all, interested parties in the UK, France and Italy, while some of those who argue in favour of maintaining the IASB's 2010 decision include prominent voices in Australia, Canada and Germany.

Those arguing for the return of prudence often say that removing it made companies less likely to act prudently and led to increased and reckless risk-taking. However, even without an explicit reference to the concept of Prudence, IFRS already prohibits many imprudent practices. To list only a few examples: companies must write down assets that have lost value. Companies must account for their liabilities, even if it is not certain whether they will have to make a payment. Companies must measure 'derivatives' at their fair value and explain the risks that these instruments expose them to. Companies must also account for debt, even if it is in the form of a lease or in complex structured finance vehicles.

Companies must account for all the costs they incur this year, even if they will not pay those costs until a future year. Companies cannot report profits this year for goods and services that they will supply to customers in future years. Our new impairment model for financial assets will also increase consistency in application. It will require losses to be recognised sooner and to be based on expected losses, addressing many concerns about the previous model.

The IASB has sought public comment on this and other aspects of our Conceptual Framework Project and we have yet to determine how to proceed. The purpose of my referring to this example is not to debate the technical merits of bringing back the word 'prudence', but instead to highlight the challenges associated with the necessary process of global standardisation in financial reporting.

Conclusion

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

During my discussion with you this morning, I have tried to describe how economic globalisation is arguably the defining characteristic of the modern era, demonstrated by the global financial crisis. I have described how this globalisation provides in my view a compelling case for global accounting standards and I have updated you on the remarkable progress towards this goal during the last decade or so.

Finally, I have described the three S's of sovereignty, structure and standardisation that make our work challenging, but no less important.

I welcome your questions and comments on these views. Thank you.