

23 June 2014

Welcome and introduction

Welcome to the 'home conference' of the IFRS Foundation. We are very pleased to be holding the conference here. As well as being a major financial centre, London is arguably the pre-eminent centre of international accounting. Not only is it home to the IASB, but also home to most of the international co-ordination offices of the large accounting firms.

As such, it is no surprise that the UK is a net exporter of accountancy services, and the accounting sector is a major contributor to the UK services economy. We are happy to do our part in reducing the UK deficit.

My discussion this morning is on the future of financial reporting. First, I will begin by focusing on the near-term future, which involves completing the major convergence projects with the FASB. Second, I will look at some of the important projects on the IASB's new work programme. Third, I will talk about how our priorities are evolving in recognition of the widespread adoption of IFRS. Finally, I would like to respond to some comments that have been recently made in the United States.

Current work programme

It is important to keep in mind why we set out on the convergence path some 12 years ago. The IASs inherited by the IASB needed improving in many areas. At the same time, according to Paul Volcker, US accounting was in 'crisis'¹ following the Enron and WorldCom accounting scandals. It made perfect sense for the IASB and the FASB to work together on improving our respective standards and bringing about their convergence.

Today, all but two of those projects have been completed. As a result, IFRS and US GAAP are both of higher quality and much more closely aligned. A great example of this is the recently issued and fully converged standard on revenue recognition. This was the 'Jewel in the Crown' of the convergence project.

The two remaining convergence projects, as well as the other major project, which is insurance accounting, are each approaching completion.

Financial instruments

Next month we expect to issue IFRS 9 *Financial Instruments*, which represents the final piece in our response to the financial crisis.

The IASB has already:

- completed its review of off balance sheet financing, resulting in amendments to IFRS 7 *Financial Instruments: Disclosure* and the issuance of three new standards, IFRS 10 *Consolidated financial statements*, IFRS 11 *Joint arrangements* and IFRS 12 *Disclosure of interests in other entities*.

¹ Prepared statement of the honourable Paul Volcker, 14 February 2002, Washington DC.

- It has also completed its reform of fair value measurement requirements, resulting in a new standard, IFRS 13 *Fair value measurement*.

IFRS 9 completes our response to the crisis by providing a comprehensive package of improvements to financial instruments accounting.

IFRS 9 introduces a new, expected-loss impairment model that limits the ability of banks and others to defer the timely recognition of loan losses and provides a logical, single classification approach driven by cash flow characteristics and how cash flow is managed. It solves the so-called 'own credit' issue, whereby banks and others are able to book large gains through their P&Ls as a result of the value of their own debt falling due to a decrease in credit worthiness. It allows companies, both within and outside of the financial sector, to better reflect their risk management activities in their financial statements. It also significantly reduces the complexity associated with the accounting for financial instruments.

The last piece in the IFRS 9 package is macro hedging, and in this regard we have recently issued a Discussion Paper entitled *Accounting for Dynamic Risk Management*. We are waiting with great interest to the responses to that paper.

Despite our best efforts, we were unable to reach agreement with the FASB on impairment. We consulted the Financial Stability Board (FSB) and others about whether to go back to the drawing board with the FASB in a final attempt to achieve convergence. However, it was decided that doing so would add several years to the project and the advice from the FSB and others was that it was more important to get the standard issued.

Leasing

The second remaining convergence project is lease accounting. Once again, this is a controversial but much-needed enhancement to transparency in the reporting of off balance sheet activities, because the numbers can be enormous.

The US Securities and Exchange Commission (SEC) in its 2005 report to Congress² said:

"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."

Following the SEC's warning, we have not been surprised by the stiff opposition that we have faced. At the same time, the changes need to be kept in context. Our own research has shown that across the industrialised world, roughly 50 per cent of listed companies report material operating leases. That means that the other half will not be affected at all by the upcoming standard.

The use of operating leases is highly concentrated. Out of the total of 12,000 entities that we analysed, 1,000 companies, or less than 10 per cent, accounted for 80 per cent of all the operating leases. We calculated that inclusion of the lease liability would lead to an increase of the long-term debt-to-equity ratio from 13 percentage points in Europe to 20 percentage points in Asia.

² 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

We have also found that within economic sectors, the use of leases is very diverse. In the transport sector, for example, there are airlines that have operating leases for almost all their aircraft. Their hidden leverage is much higher than the numbers I just mentioned. Other airlines already carry most of their fleet on the balance sheet and will not be affected by the new standard.

To sum up our effect analysis: it shows clearly that the Leases standard will only affect significantly fewer than 10 per cent of listed companies. In effect, we are institutionalising aspects of best practice. However, in the economic sectors that are significantly affected by the Leases standard, it brings much needed insight in the true leverage of companies.

While only a minority of companies will be significantly affected by the Leases standard, we are aware that this change will not be without cost to preparers. We have already made some pragmatic decisions to help keep costs to a minimum, and we are motivated to look for improvements that will make the standard less costly to implement and apply.

We are also motivated to ensure that the new standard responds to the needs of investors and other users of financial statements. That is why our outreach has included almost 300 meetings with investors, with many of those meetings taking place in Europe.

Insurance accounting

The third major project to be concluded, although not one of the original convergence projects, is our work to develop a new accounting standard for the insurance industry. To give some context, this project began in 1997—17 years ago. Even today, some argue that we are going too quickly, and that more time is needed for our deliberations.

As you may know, the existing IFRS 4 is a stopgap measure that basically says ‘carry on what you are doing’. As a result, a wide range of practices has been allowed to develop. Bringing this diversity back into line with a new Insurance standard is going to cause controversy. However, it is an important project that will deliver long-term significant benefits to the insurance sector.

New work programme

With the end of the convergence programme in sight, our attention has turned to the projects that feature on our new work programme. During my brief remarks this morning, I will focus on two of the most important projects. The first is the review of the *Conceptual Framework* and the second is our project on financial disclosures.

Conceptual Framework

Although the *Conceptual Framework* is not an actual standard, it fulfils an important role by providing the IASB with a consistent point of reference in the development of standards and a place where preparers can understand the underpinning of our standards. There are several important areas that are being addressed by this project.

First, we are taking a look at measurement, and in particular we are looking at the different measurement bases and the information they provide.

Second, we are attempting to provide a clear conceptual separation between what goes in Profit and Loss vs. what ends up in Other Comprehensive Income.

Third, as part of this project we have also sought feedback on our decisions back in 2010 to remove the word 'prudence' from the *Conceptual Framework* in favour of 'neutrality'. We still believe that neutrality is an essential concept in financial reporting. However, some commentators have interpreted the removal of the word 'prudence' as the IASB giving a green light for 'imprudent' reporting. We disagree with this interpretation. However, it is unhelpful for this perception to continue, so in May this year the IASB tentatively decided to reintroduce the word 'prudence' into our *Conceptual Framework* while also making it clear that being prudent does not mean introducing bias.

Fourth, we have given further consideration to how the concept of stewardship is dealt with in the concepts and the IASB tentatively decided to increase the prominence of stewardship within the overall objective of financial reporting.

But you can't win them all, and, fifth, the IASB tentatively decided not to replace the characteristic of faithful representation with reliability.

We expect to publish an Exposure Draft of the new *Conceptual Framework* later this year and we await your comments with interest.

The Disclosure Initiative

The second major project on our new agenda is a comprehensive review of financial disclosures. It is a common complaint that the size of annual reports is ballooning, while the amount of useful information contained within those disclosures has not necessarily been increasing at the same rate. The risk is that such reports become compliance documents rather than instruments of communication.

There are many reasons for why this has happened. Business has become more complex. Some companies are reluctant to trim back the amount of information disclosed, for fear of needing to restate information. Some auditors have a tick-box mentality, while the accounting standards themselves are often blamed for encouraging such behaviour.

Last year, we hosted a conference with a range of interested parties to discuss this issue, and as a result of that discussion we have created a 10-point plan to drive changes in behaviour, including our own behaviour. That plan included a series of short-term measures, as well as a few longer-term actions. The shorter-term measures include targeted amendments to IAS 1, a project to consider proposals to amend IAS 7 to require the disclosure of changes in liabilities classified in financing activities and a look at how materiality works with accounting policy disclosures.

The longer-term project, which will deal with the principles of disclosure, has an aim of developing a disclosure standard to replace three of our current standards, IAS 1, IAS 7 and IAS 8.

Evolution in priorities

The third topic that I wanted to touch upon is the manner in which our priorities have evolved as IFRS has become established as the de facto global set of standards for financial reporting. In the last decade, IFRS has come from nowhere to its use now being mandatory in more than 100 countries, while most of the remaining countries are well advanced in their transition to IFRS.

For example, Singapore has just announced its intention to fully adopt IFRS while only last week the Japanese government unveiled a draft of its 'growth strategy', which describes steps to accelerate the already significant adoption of IFRS by Japanese companies, providing enhanced transparency and in turn promoting inward investment.

As the number of countries yet to fully adopt IFRS decreases, attention turns from building out IFRS adoption to further deepening our collaboration with IFRS jurisdictions around the world, as well as encouraging consistency in the application and implementation of our standards.

Deepening co-operation

The development of IFRS has long been a deeply collaborative process, involving interested parties from around the world. However, during the decade of convergence, we have out of necessity needed to prioritise our working relationship with the FASB. Now, though, as the convergence projects are coming to an end, we have moved from a largely bilateral working relationship with the FASB to a more multilateral approach of working with standard-setters around the world, although still including the FASB. The primary vehicle for this interaction is what we call the Accounting Standards Advisory Forum, or ASAF.

The ASAF provides an excellent forum for representatives of regional and national bodies with an interest in standard-setting to exchange views with the IASB about the future development of IFRS. We find the ASAF meetings incredibly useful because any ASAF member can present his or her views, but those views are then subject to peer review by others. For example, ideas about the development of IFRS presented by colleagues at the FASB are debated with colleagues from Europe, Africa, Asia and South America as well as the IASB itself. This aids the understanding of issues by all concerned.

Encouraging consistent application

In addition to our co-operation with the standard-setting community, we are also seeking to encourage greater consistency in the application of IFRS internationally. The 130 jurisdictional profiles published on our website show that IFRS is used as intended around the world. Adjustments are few, and where jurisdictions do make adjustments they are generally regarded as a temporary step to aid the transition to full IFRS.

However, as the 2012 SEC staff report noted, the financial reporting community still has work to do to improve consistency in the application of IFRS around the world. That is why in 2012 the Trustees of the IFRS Foundation recommended that we should strengthen our relationships with securities regulators and others around the world. Last year, we agreed a Statement of Protocols with IOSCO, the international network of securities regulators, that describes steps that the IFRS Foundation and IOSCO will jointly undertake.

Of course, this work is only possible because of the widespread adoption of IFRS as the single set of high quality, global accounting standards. Unfortunately there are no short cuts. Indeed, the history of accounting standard-setting is littered with failed models of international co-operation.

For example, between 1973 and 1998, nine of the largest economies, including the United States, worked together to minimise divergence between their respective national accounting standards, using International Accounting Standards as the benchmark³.

It was a very attractive idea, but unfortunately one that in practice failed miserably. Each of those nine countries continued to have very different sets of accounting standards, each incompatible with the others.

The reason was simple. Each country took only those international standards that were consistent with their own preferences. If the preferences of the national standard-setter were different, then they did their own thing. Each country had different preferences in different areas, and hence there was no international comparability.

Turning back the clock?

That is why after 25 years of trying, the international community decided to scrap this approach and instead threw their combined efforts into developing a single set of standards, developed through extensive international consultation and capable of being applied on a globally consistent basis.

As we all now know, that model has been a remarkable success. Today, IFRS is mandated for use by more than 100 countries, while most other countries permit the use of IFRS in some shape or form. Pretty much every international organisation, including the G20, has supported this model and continues to do so.

For that reason, I find it interesting to note that in recent speeches, various members of the FASB have begun to present a vision of international standard-setting that is remarkably similar to the old IASC approach. This is an approach whereby major economies maintain their own accounting standards, using IFRS as the international benchmark and seeking to reduce their differences. The problem is that in this view, differences between accounting standards would persist. As Jim Kroeker, Vice chairman of the FASB recently said: *“(...) we recognize that one size may not fit all. By that, I mean that we understand that differences in standards will persist because of the legal, regulatory and cultural differences among different jurisdictions.”*

Indeed, the 2013 FAF Annual Report⁴ states that “Even as we commit ourselves to global convergence, the FASB’s first priority is to improve GAAP for the benefit of all GAAP stakeholders.” When talking about the divergences between the two boards on leasing, financial instruments and insurance, the FAF deems that “(...) the FASB’s action (is) consistent with its mission to first improve GAAP and then converge if possible” (p. 7).

If divergences are more or less accepted as inevitable, it can be no surprise they become the norm rather than the exception. If all IASB constituents were to insist on the primacy of national preferences, obviously the goal of a single set of global standards would come to naught. That was the old IASC approach. We tried it for 25 years and it failed.

³ The International Accounting Standards Committee was formed in 1973 by the principal accounting bodies in Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the United Kingdom and the United States – see Camfferman & Zeff (2007), *Financial Reporting and Global Capital Markets: A History of the IASC, 1973-2000*, Oxford

⁴ 2013 Annual report of the US Financial Accounting Foundation, www.accountingfoundation.org

Moreover, I do not buy the argument that cultural differences mean that a ‘one size fits all approach’ cannot work. Our Board and staff work incredibly hard to develop principle-based standards that can be adopted by countries around the world, regardless of their stage of economic development and their legal culture. As a result, countries with cultures as diverse as Brazil, Canada, Colombia, Germany, Japan, Korea, Mexico, Nigeria, Turkey and of course the United Kingdom have all adopted IFRS without major issues. Indeed, there is more cultural diversity between the UK and France than between the UK and the US, yet both France and the UK report using IFRS.

Furthermore, more than 500 foreign companies listed in the US already apply IFRS, so the evidence would appear to show that in financial reporting, one size can indeed fit all—if the will is there to make it happen.

As I noted before, more than 100 countries, representing the major part of worldwide GDP, are today speaking the same financial reporting language. This is a clear validation of the IFRS model compared to the failure of the IASC model. Now is not the time to turn back the clock, and thereby put at risk the hard-fought gains of the last decade.

Last week I read an interview⁵ with Russ Houlden, CFO of United Utilities and Chairman of the Financial Reporting Committee of the Group of FTSE100 Finance Directors. He said

“Globalisation is here to stay, which means global standards are essential. While the creation of a truly global set of standards may take another ten years or more, it is inevitable. Those who want to turn back the tide are like King Canute sitting on the beach.”

Or perhaps it is more relevant to quote Paul Volcker, the legendary former Chairman of the US Federal Reserve, who recently said⁶:

“If we really believe in open international markets and the benefits of global finance, then it can’t make sense to have different accounting rules and practices for companies and investors operating across national borders. That is why we need global standards. Ultimately this will get done.”

I could not have put it better myself.

Close

Ladies and gentlemen, I am grateful for your attention. I set out to update you on our perspectives on the future of financial reporting, both in the near and medium term, but also on how the priorities of the IASB are evolving to reflect the remarkable success of IFRS and how we are planning to continue on the path towards one set of global standards.

I look forward to further debate on these topics during the conference and I am happy to take your questions, now or later in the day.

⁵ Issue 10 (July 2014) of “By All Accounts”, www.icaew.com

⁶ “IFRS as global standards: A pocket guide”, to be published July 2014, www.ifrs.org