

Closing the accounting chapter of the financial crisis

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Introduction

Ladies and gentlemen, I am delighted to join you today at this Asia-Oceania Policy Forum here in New Delhi. On behalf of the IASB, I would like to thank the Institute of Chartered Accountants of India, or ICAI, for hosting this important event.

The dynamism of this part of the world is redefining the global economic landscape. The same is true in accounting standard-setting. Many of the ideas that permeate our Standards have originated from work led by standard-setters in this region. More than a quarter of my Board originate from this region, and Asia is home to our only international office.

The IFRS jurisdictional profiles also tell a positive story about Asia-Oceania's commitment to IFRS. Of the 22 profiles we have been able to create thus far for this region, 15 jurisdictions require IFRS for all listed companies, while Indonesia and Thailand have plans for full adoption. In three other jurisdictions, the use of IFRS is permitted. In Japan, the voluntary use of IFRS is becoming quite significant.

Of course, we hope that we will soon be able to count our host India among the full adopters of IFRS. The *Indian Economic Times* reported last month the views expressed by President Raghu of the ICAI, when he stated that “[India has] no choice but to align [itself] with what is happening globally¹”. Indeed, full adoption of IFRS would greatly strengthen the appeal of the Indian capital market to foreign investors. As Chairman of the IASB, I am committed to supporting you at every stage of this process.

Financial reporting and the financial crisis

This morning, I will focus my remarks on one particular topic, and that is the impact of the global financial crisis on financial reporting.

In the next few months we will publish the Impairment and Classification and Measurement chapters of IFRS 9 *Financial Instruments*. They represent the final elements of the IASB's response to the global financial crisis. That response was guided largely by the recommendations of the Financial Crisis Advisory Group, or FCAG.

¹ “India to adopt global financial standards from April 2015”, *The Economic Times*, 24 February 2014

The FCAG was formed in 2009 to advise the IASB and the FASB. The group consisted of senior leaders with broad international experience in the financial markets, standard-setting and regulation. In a quirk of fate, I served as co-chairman of the FCAG, still blissfully unaware of my future role as Chairman of the IASB.

One of the key findings of the FCAG was to emphasise the role of financial reporting in providing unbiased, transparent and relevant information. However, the FCAG also recognised that only so much can be expected of accounting. Yes, accounting standards could contribute to financial stability by providing transparency. But, no, we should not expect accounting standards to provide a veneer of stability by ignoring volatility when it is really there.

The FCAG also made more specific recommendations with regard to our standards. The most important were the following:

- improving the accounting for what is on or off balance sheet and the related disclosures;
- fixing the so called ‘own-credit’-problem: the counterintuitive result of entities booking gains when the value of their own liabilities fall as they become more likely to default; and
- devising a more forward-looking impairment model for loan loss provisions.
- Finally, the FCAG urged the FASB and IASB to come to converged solutions.

In 2009, the G20 issued a similar message to the Boards. In short, the G20 called on the IASB and the FASB to improve standards on valuation and provisioning and to achieve a single set of high quality global accounting standards.

Our response

So how has the IASB responded to the financial crisis and the recommendations of these parties? Well, we undertook a variety of projects to look at areas that needed improvement. I will outline three below.

First, Fair Value Measurement. The fundamental question was how to apply mark-to-market accounting when there is no active or well-functioning market. In IFRS 13 *Fair Value Measurement* we provided more guidance on how to determine fair value in illiquid markets. While fair values are often seen to be equivalent with exuberance, this Standard actually requires risk adjustments when mark-to-model valuations are used.

Second, we improved accounting for off balance sheet items. The main issue in this area was to do with Qualifying Special Purpose Entities in US GAAP, which had led to widespread off balance sheet financing in the United States.

IFRS did not have such a concept and our off balance sheet requirements held up well. Still, we decided that disclosure about exposures to off balance sheet items could be improved. We decided that if you have a relationship with an off balance sheet structured entity then disclosures are required about the risks and the nature of the relationship. And, in a related project on consolidation, we affirmed control—not just majority ownership—as the basis for consolidation.

Third, we set out to reform financial instruments accounting. This has been our main response to the financial crisis. Our work on classification and measurement of financial instruments focused on when such instruments should be measured at fair value, and when amortised cost should be used.

We introduced a more logical approach for determining the way in which a financial instrument is classified. The new model bases classification partly on an entity's business model for managing their financial assets.

We have recently made incremental improvements to this approach introducing the concept of a business model where assets may be held either to sell or to collect contractual cash flows. This change will not narrow the amortised cost business model in IFRS 9. Furthermore, we have made it clear that financial instruments with interest rates set by government rather than being directly linked to market interest rates are eligible for amortised cost measurement.

We also dealt with the counterintuitive accounting for an entity's own liabilities when they are measured at fair value. Previously, if an entity's credit quality deteriorated so that the value of its debt fell—that resulted in a gain being booked in profit or loss. This has been fixed.

Finally, we looked at requirements for how to determine loan loss provisioning. Accounting standards around the world, including IFRS, US and UK GAAP, are currently based upon the incurred-loss impairment model.

The incurred loss model was designed to limit management's ability to create hidden reserves during the good times that could be used to flatter earnings during the bad times. This kind of earnings management was deemed to be misleading to investors.

However, during this most recent crisis the model has been accused of resulting in impairment being 'too little, too late'. While we believe that the model could have been applied in a more stringent manner, it is also a fact that it could easily be used for a very restrictive attitude towards provisioning.

In practice, during the crisis the existing model was, in many cases, applied so that impairment was only recognised just before a loan defaulted.

This meant that loan losses were often recognised far too late. As a result, many investors lost trust in the quality of banks' balance sheets.

The incurred loss model also tempted many banks to “extend and pretend”. They continued providing credit to entities that were in big difficulties, while loans to companies with growth potential were being choked off.

Furthermore, when something was impaired there were different ways in which it could be measured. Put simply, two entities could own the same asset and recognise completely different impairment amounts depending on how they measured the asset on the balance sheet. This was confusing for readers of the financial statements.

We have addressed these two issues by introducing a single impairment model—any financial instrument subject to impairment accounting will have impairment measured in the same way.

The new expected loss model recognises that whenever you buy a financial asset or lend money there is always some level of expected losses associated with it. Full lifetime expected losses need to be recognised when significant credit deterioration has taken place. This should happen long before an actual default takes place.

We must however be careful that we do not introduce changes that address the previous crisis but that in doing so, sow the seeds for the next one. That is why, in developing our expected loss approach, we have been careful to limit opportunities for earnings management. To help avoid this, part of the model is a package of disclosures that we have provided to explain the assumptions used and the source of changes in allowance balances from period to period.

We did not just make progress; there was also disappointment. We did not succeed in one central recommendation of the FCAG and G20, and that is in the area of convergence in the IASB's and the FASB's Standard for financial instruments. On Classification and Measurement, Offsetting and also Impairment, we had at some point reached converged positions with the FASB. With regard to Offsetting and most likely with Classification and Measurement the FASB in the end reverted to existing practice in the United States. We also did not manage to stay converged on Impairment, which was one of the main recommendations of the FCAG.

This inability to deliver compatible outcomes with the FASB clearly demonstrates the inherent instability of convergence as a means to achieve a single set of global accounting standards. For this reason, our Trustees wisely concluded that convergence can never be a substitute for adoption of IFRS. Thankfully, throughout the financial crisis, the momentum towards adoption has continued unabated in many countries

Conclusion

So will our work on financial instruments, on the improved transparency of information and the timeliness of impairment allowances help avoid the next crisis?

I think that the good news is that if our measures are properly applied there should be far fewer surprises. It should be clearer what risks an entity is exposed to. When there are changes in credit expectations that should be reflected in loan loss provisions.

In addition, an expected loss model will lead to a much more timely recognition of losses. That should lead to a more efficient allocation of capital. Quicker recognition of credit losses means quicker recovery of credit flows to companies that do have a future.

At the same time we have to be realistic. If we move to an expected credit loss model, then expected credit losses should be properly reflected.

But the clue is in the name—those losses need to be expected to be reflected in the financial statements. As we approached the financial crisis the market was *not expecting* the losses that were about to hit.

So it remains to be seen if an expected credit loss model in itself can predict the next crisis. Financial reporting is only as good as the information upon which it is based. More importantly, financial reporting must be properly understood and used.

In fact, I remain convinced that pre-crisis IFRS delivered all the essential information for market participants to see that trouble was brewing. IFRS requires just about everything to be put on the balance sheet, including special purpose vehicles and derivatives. So everybody could have seen that the banks were leveraged 30, 40 or even more than 50 times. Everybody could have seen that the banks had next to no tangible capital.

In sum, IFRS clearly showed the biggest dangers in the financial system. But these dangers were so big and manifold that most people simply closed their eyes to them. Accounting in itself cannot overcome the periodic collective madness of financial markets.

Having said that, we remain committed to improving our Standards where we can. With the completion of IFRS 9, as well as the other elements of our response to the financial crisis that I have described, we have come a long way. We look forward to continue working with you and with the regulatory community, to make the financial world a safer place.

Ladies and gentlemen, thank you for your attention today.