

“Charting progress towards global accounting standards”

Hans Hoogervorst, IFRS Conference Singapore, 29 May 2014

It is a great pleasure to be here in Singapore. As one of the most phenomenal economic success stories in the world, I have always followed developments in Singapore closely. Your country is one of the best examples of what a combination of visionary and pragmatic leadership can achieve.

I want to discuss two topics with you today. First I will give you an overview of the current use of IFRS around the world and especially in this region. In the second part of my speech I will discuss elements of our current work programme.

I think it is fair to say that the spread of IFRS around the world has been an astonishing success. 10 years ago, nobody used IFRS, now it has spread to all corners of the world. But until recently, we did not have a very precise picture of the actual use of IFRS around the world. Some suspected that the adoption of unmodified IFRS was actually limited. They assumed most jurisdictions were actually applying modified versions of the standards, tweaked according to their own needs.

In the last 18 months, we have been working hard to get a fuller picture of IFRS use around the world. We collected objective evidence which was validated by the relevant authority within each country. So now we have a reliable, central source of information about the actual use of IFRS around the world. Thus far, we have completed 130 jurisdictional profiles, which you can find on our website. They make fascinating reading.

The first conclusion we can draw is that of these 130 jurisdictions, 105 require the use of IFRS for all or most companies. 14 more permit the use of IFRS in their jurisdiction.

Although some big economies are still missing, the countries where IFRS is used already cover more than half of the world's GDP. Another interesting fact is that the use of IFRS is no longer concentrated in Europe. The spread of IFRS in the Americas, Asia and Africa is such that the combined GDP of non-European jurisdictions is over \$23 trillion, more than the combined EU-GDP of \$17 trillion.

In Asia-Oceania, the dynamics for IFRS are still strong. Of course, Australia and New Zealand are fully on board. So are Asian tigers like Korea, Malaysia, and Hong Kong. Singapore will probably fully adopt soon and Thailand and Indonesia have advanced plans for adoption. China has not yet adopted, but its standards are very close to IFRS and the Chinese government is committed to full convergence as a final goal.

Japan is an interesting case. It has not fully adopted, but allows individual companies to adopt IFRS voluntarily. This is now happening at a very rapid pace. The number of IFRS adopting companies in Japan has doubled from 20 to 40 over the past year. The Keidanren expects about 60 companies, representing 20% of the Tokyo market cap, to have adopted IFRS by the end of next year. So the Japanese are getting there.

What is more important is that of these adopters, only a few have made modifications to IFRS. Mostly, such modifications are very small. For example, the European carve-out from IAS 39 has been used by fewer than two dozen out of 8000 listed companies in the European Union.

Moreover, where such modifications have occurred they are meant to be temporary arrangements in the migration from national GAAP to IFRS. In almost all of these cases, we have active projects on our agenda that address these issues, including agriculture, revenue recognition and separate financial statements. The end result will be that most of these modifications will likely disappear.

This success begs the question why so many countries have been motivated to adopt IFRS. For Europe, it was simple: they could not have a single financial market with 20 different accounting languages. For many emerging countries (Brazil, Korea) it was an easy way of enhancing the international credibility of their financial markets. World leaders (G20) saw it as a logical underpinning of the global economy. Research bears out that indeed cost of capital has been lowered in many countries. For multinational companies the use of one single financial reporting language for both internal and external reporting is simply cost efficient. The fact that so many Japanese companies adopt voluntarily is the best evidence of the business case for IFRS.

Revenue Recognition

Yesterday was a memorable day as we published the new Revenue Standard. It is a very important Standard because it is about the top line and it affects every entity's financial statements. That is the reason why I call RevRec the jewel in the crown of convergence.

As I indicated before, the new Revenue Recognition Standard should address most of the concerns regarding the "percentage of completion" method of accounting that are prevalent in the construction sectors in some Asian countries.

The new Revenue Standard replaces American standards that contain thousands of pages of application guidance and IFRS Standards that provide too little guidance. The fact that we managed to stay converged with our colleagues of the FASB is very important and we intend to stay converged in the future.

That is one of the reasons why we created a joint transition group, which will guide preparers in the implementation of the new Revenue Standard. We expect the transition group to answer the vast majority of the questions that inevitably come up with market participants. Should more fundamental questions be raised, they will be referred to the Boards.

Leasing

Second is lease accounting, another difficult but very important area. Currently, most 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 transportation, telecommunication and retail companies, the leverage caused by leases can be substantial. We have conducted an effect analysis of the leases Standard among 12.000 listed companies in Europe, Asia and North America. Our analysis has led to some interesting insights.

First of all, in the industrialized world, roughly 50% of listed companies report material operating leases. That means that the other half will not at all be impacted by the upcoming standard.

Secondly, the use of operating leases is highly concentrated. Out of the total of 12.000 entities that we analysed, 1000 companies, or less than 10%, accounted for 80% of all the operating leases. For these 'heavy' users, operating leases are a very significant source of finance. 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 through 20 percentage points in Asia.

These substantial numbers explain why many investors make adjustments to the balance sheet in their analyses.

We have also found that within economic sectors, the use of leases is very diverse. In the transportation sector, for example, there are airlines that have operating leases for almost all their airplanes. 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 impacted by the new Standard. In all, there can be no doubt that the leases Standard will greatly enhance comparability between and within economic sectors.

To sum up our effect analysis: it shows clearly that the leases Standard will only affect significantly fewer than 10% of listed companies. However, in those 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 lease Standards, we are aware that this change will not be without cost to preparers. We have already made some pragmatic decisions to keep costs to a minimum, such as the exclusion of short-term leases and variable lease payments. Last month, we also decided to include guidance on how to use a portfolio approach for leases. We are motivated to look for improvements that will make the Standard less costly to implement and apply.

While we have reached agreement with the FASB that most leases need to be put on the balance sheet, we have less agreement about how the lease liability should be run off in the income statement. I will not bore you with the details, but more work needs to be done. In the next couple of months we should be able to finalise our work.

IFRS 9

This spring, we also finished our deliberations on IFRS 9 *Financial Instruments* and we issue the new Standard in July. IFRS 9 contains several improvements over current accounting. Let me highlight just two.

First, we dealt with the so-called ‘own credit’ problem. Previously, if an entity’s credit quality deteriorated so that the fair value of its debt fell—that resulted in a gain being booked in profit or loss. This very counterintuitive result has now been fixed.

The most important improvement of IFRS 9 relates to 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’. 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.

For this reason, we decided to move from an incurred loss model to an expected loss model. 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.

In all, the expected loss model will be much more forward looking than the incurred loss model. It will result in a more realistic recognition of impairments. Banks will have to clean their balance sheet in a more timely fashion. This is good for investors, who can have more faith in a bank's balance sheet. It is also good for the economy, as credit will stop flowing to zombie companies and resources are freed up for companies that do have a future.

Disclosure overload

I travel all around the world to spread the gospel of IFRS and wherever I go I hear the same concerns about financial reporting. People complain about complexity, about financial reports becoming ever lengthier, about the real message getting drowned in excessive disclosures.

I fear that most of this complexity is a reflection of an increasingly complex economic reality. If we really want simple reporting, we should do away with derivatives, defined benefit pension schemes should go out of the window, companies should stop dressing up liabilities as equity instruments, insurers should stop mixing insurance with investment products and the list goes on...

Clearly, this is not going to happen, so complexity is a reality we have to live with. But there are things we can do to make complexity more manageable. One of these is the IASB's disclosure project.

We share the widely held view that often disclosures do not contain useful information. Many aspects of the disclosure problem have to do with behavioural factors. For example, many preparers will err on the side of caution and throw everything into the disclosures. They do not want to risk being asked

by the regulator to restate their financials. After all, no CFO has ever been sacked for producing voluminous disclosures, while restatements may be career-limiting.

Furthermore, sometimes it is just easier to follow a checklist, rather than put in the effort to make the information more helpful and understandable. Such risk aversion, although understandable, can lead 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? In July last year, I presented a 10-point plan to deliver tangible improvements to disclosures in financial reporting.

We worked quickly and produced an Exposure Draft to make some changes to IAS 1 in March of this year. The proposed changes are very simple. We make clear that immaterial information should be avoided if it threatens to overshadow material information. It also makes clear that if information is deemed immaterial for the financial statements, it should probably also be avoided in the notes. We will also give more flexibility as to the order in which you present the notes. Simple changes, but these are usually the most effective at tackling seemingly intractable problems.

In the next stage of the project we are going to work with securities regulators, preparers and auditors to see how materiality is used in practice. If necessary, we will develop more application guidance as to how to apply materiality.

We are also starting a research project to develop clearer principles of disclosure. Once that is finished, we will undertake a cross-cutting review of all

our Standards and make our disclosure requirements more consistent and easier to apply.

We have asked our staff to produce tangible results throughout this reform programme. There is already a long list of reports on the disclosure problem; what we need now are concrete improvements.

Through this project, we hope to take away many of the excuses for taking the easy route of just publishing boilerplate disclosures. Hopefully it will help to ignite the much-needed change in the mind-set of preparers, auditors and regulators that is so sorely needed. The IASB will continue to engage with our constituents to facilitate the joint effort that is needed to make disclosures less indiscriminate and more meaningful.