ACCA

Evaluating the impact of IFRS in the EU

25 September 2014, European Parliament, Brussels

REPORT

On 25 September 2014, ACCA (the Association of Chartered Certified Accountants) organised a conference on **“Evaluating the impact of IFRS in the EU**", hosted by **Theodor Dumitru Stolojan, MEP**, to both present and discuss the recently published consultation on the evaluation of the IAS Regulation and the potential ways forward. Stakeholders discussed the quality of IFRS, their costs and benefits in Europe, their enforcement and whether there should be changes to the IAS Regulation. **Didier Millerot**, head of the Accounting and Financial reporting unit of the European Commission explained the framework in which the consultation was taking place.

The roundtable was moderated by **Richard Martin**, ACCA Head of Corporate Reporting, **Vincent Papa**, CFA institute, **Claes Norberg**, BusinessEurope, **Ricardo Sanchez Fernandez**, EBF, **Mark Vaessen**, FEE, **Melanie McLaren**, FRC, **Pr Colin Haslam**, Queen Mary University, and **Olivier Boutellis-Taft**, CEO, FEE.

The debate revealed that

- Though capable of improvement in a number of respects, IFRS are generally meeting their objectives in terms of capital markets.
- Important changes to IFRS in the pipeline - including IFRS9 the new standard on financial instruments - were noted as moving in the right direction.
- Though the panel found it difficult to isolate and quantify the incremental running costs of IFRS, they all agreed that there had been much greater benefits in terms of a single language of accounting in Europe and the costs of capital for listed companies.
- As regards to enforcement, speakers thought that the use of IFRS had a positive impact on the consistency of the application of the standards across the EU and on the quality of national enforcement. Some stressed however that if IFRS is a common language there remain some national/regional dialects, which in some cases, run the risk of creating an unlevel playing field. There was also a call for improvements in the field of coordination from ESMA (European Securities and Markets Authority).
- The conference did not identify significant reasons to change the Regulation, either in terms of the scope of its application or the criteria used in the endorsement process. The Commission noted that they were conducting an ex-post evaluation of the Regulation with no preconceived ideas. They did not commit at this point to new legislative change.

Main highlights

Theodor Dumitru Stolojan, MEP

- The EP has approved the co-financing the IFRS Foundation, EFRAG and the PIOB. The report was finally passed and it became legislation. The European Commission is now committed to come out with conclusions drawn from the public consultation by the end of this year.
- There are pleasant news regarding the spreading of IFRS in the world. Progress in this area is there and this is very encouraging.
- It is important to stress that this evaluation and the public consultation should give us signals regarding the conceptual framework that was publishes by IASB. At the moment these are just projects, not final decisions. We expect to learn more about the conceptual framework from experts and academics in the future.
- When the European Parliament received the report, we thought this would be an easy task. However suddenly we were put in the middle of a very passionate academic and political debate on IFRS that went far beyond the pure co-financing issue. MEPs were not prepared for this unexpected sudden issue, as we did not have immediate sufficient knowledge about accounting standards and we had to learn. There was much disagreement on this in the European Parliament, particularly on the principles behind the IFRS (notably, on including references to “prudence”). The debate is far from being over; emotion is still very present for some MEPs and the European Parliament. We are looking forward to receiving the report from the Commission on the IAS evaluation by December.

Didier Millerot, **Head of the Accounting and Financial Reporting unit, European Commission, presented the EC consultation on the evaluation of the IAS Regulation**

- We are in the middle of the public consultation process on the impact of IFRS in the EU. This consultation takes place in the framework of the evaluation of the IAS Regulation, an exercise of better regulation. Its goal is to assess whether the initial objectives of the Regulation have been achieved and whether they are still relevant today. The initial objectives were the transparency and comparability of financial statements of consolidated accounts of listed companies, which should in turn attract investors, both in the EU and internationally; and promote and contribute to the establishment of high quality international accounting standards. The evaluation will also look at the impact of the move towards IFRS for the functioning of the single market and also at costs and benefits.
- The evaluation will also look at the mechanics of the endorsement process set in the regulation. Standards can only be adopted if they satisfy endorsement criteria provided by the regulation. It has to be evaluated whether the system is workable and if it needs to be improved.
- At last, the evaluation will look at the governance in general. There are different bodies involved and EFRAG plays a very important role in advising the Commission on technical issues before it takes the decision. The EU contributes to the budget of the IFRS Foundation and of EFRAG and we need to make sure they function at the highest standards possible.
- The Commission conducts its evaluation with the help of a dedicated expert group which brings together representatives from the industry and competent public authorities. This knowledgeable group will accompany the work along the process. Specific discussions will take place on issues such as the endorsement criteria and the economic impact of applying the IFRS in the EU. It is not sufficient to enforce the standards - they need to be properly

applied. The expert group will also discuss the replies to the public consultation. The Commission also takes also into account.
- The results of the online public consultation, along with these other work streams and with the recommendations of Mr Philippe Maystadt on governance issues, will lead to a European Commission report, which will hopefully be ready before the end of the year.
- The report will be issued by the College of Commissioners. Jonathan Hill will be responsible for this file, if the Parliament approves his appointment.
- The outcome of the evaluation will not necessarily lead to a new proposal of legislation for financial reporting. We need to see what the results are first and only then draw the conclusions and make well informed decisions.

Panel discussion

Moderated by Richard Martin, Head of Corporate Reporting at ACCA. He noted that though capable of improvement in a number of respects, IFRS are generally meeting their objectives in terms of capital markets

Vincent Papa, **Director of Financial Reporting Policy, CFA institute**
- The general satisfaction by investors with IFRS does not mean that IFRS statements have no room for improvement. In fact, investors do have a wish list for improvements. But it is also worth pointing out that the areas of improvement for IFRS are not unique to IFRS- the same deficiencies that exist under IFRS are identifiable under US GAAP and for that matter any other national GAAP. In fact, the financial reporting framework is far from perfect.
- The changes that investors would hope to see:
    1. **Elimination of avoidable complexity due to avoidable options**: it is understandable that different business models necessitate different accounting approaches. For example, the appropriate choice of how to depreciate assets depends on the business models. However, there are cases, where IFRS standards allow options that simply curtail the comparability of similar things. Another example of avoidable complexity is the presentation of interest paid on the cash flow statement. There is flexibility on whether to present interest paid as an operating or financing cash flow- and this existing flexibility in presentation curtails the ability of investors to make immediate comparisons of cash flow from operations across similar business models- when these business models classify interest paid differently on the statement of cash flows.
    2. **Ensuring disclosures tell the economic story**: sometimes there seems to be an undue emphasis on the representation of earnings- rather than telling the whole story of risk management. In this respect it is encouraging that recent standard updates have been trying to enhance disclosures and crucially that there is an ongoing dialogue about a disclosure framework.
    3. **Tackling limited comparability in the recognized amounts and disclosures across EU countries**: CFA Institute has recently completed a study reviewing the loan fair value disclosures and impairments of banks across different EU countries. We found discernible differences that cannot be readily explained by differing economic reality of these banks across different countries- leading to the conclusion that these differences were likely reflecting inconsistencies in the application of the standard. It is intriguing as to what the root causes of these differences across countries are- and there is likely need for a more robust enforcement regime across different EU countries.
- This debate needs to go beyond the existing standards. In the last few years there have been some significant enhancements of IFRSs. It is easy to judge the benefits of some of

the standards, but it will take longer time in some areas before you can make proper judgement as to how it can be beneficial for investors. Hopefully performance reporting will be another key project that will be undertaken by the standard setters to address the issues that are of concern to investors.

Pr Colin Haslam, **Queen Mary University, London**

- The gains arising from IFRS adoption by EU firms is a question of how these benefits are framed. The general argument is that IFRS enhances accounting disclosures to inform investors (and creditors) about financial performance and risk. The evolution and significant inflation of disclosures in the financial statements is justified, it is argued, because it supports the objective of improving capital market efficiency. That is, reducing the agency gap between what managers and investors know about financial performance and risk, facilitating effective capital stack allocations and attracting inward capital flows into the European Union.
- Academic studies generally find that equity investors react positively to the adoption of IFRS comparing pre and post IFRS adoption event time periods. That is, information content and comparability improve investor knowledge and generate, in return, lower risk premiums reducing the cost of capital and promoting capital market allocation efficiencies. In countries where equity-based financing dominates, and corporate disclosure quality is already high, the implementation of IFRS appears to be more effective in closing the agency gap and cost of equity. In debt-based or bank based financial systems IFRS accounting standards have also associated with an inflated provision of debt financing relative to operating surpluses. However, in the main European economies that employ IFRS the stock of outstanding bank assets, equity and debt financing have steadily inflated to levels that are now averaging 6 times Gross Domestic Product (GDP). The Philippe Maystadt report published a year ago in October 2013 suggests that accounting standards need to be more “European” and that this involves reflecting the public interest through the promotion of financial stability. The suggestion in this report is that accounting was implicated in the financial instability of capital markets in the recent crisis because assets values were increasingly marked to market.
- Accounting standards setting bodies such as the IFRS have not been standing still because there is always the need to react and accommodate to the demands of regulators and policy makers. IFRS 9 Financial Instruments, for example, incorporates expected loss impairment models that require a more timely recognition of expected credit losses with counterparties. It also introduces the notion of the ‘business model’ which provides for the classification of financial assets not simply driven by cash flow characteristics but also the nature of the reporting entities business model because this informs the purpose for which the asset is held. All of this means that that the use of fair value measurements will become less generalised and where it is employed, in financially leveraged business models, risk containment and stress testing will need to be incorporated into disclosures to reflect regulatory and legislative change.

Melanie McLaren , Executive Director Codes & Standards, FRC

- The IFRS progression has been very successful, but that does not mean it has been absolutely perfect and that we all can speak to one another in one language without any dysfunction. From a policy perspective we very much support anything that moves towards having more communality and being able to converse in one language. That is what essentially the accounting standards were doing.

- Many firms in the UK chose to opt for IFRS because this makes them attractive for investment. There is a value in using that as a system. From a practical knowledge, this is attractive to business in terms of communicating and reaching out to investors. It is overall a beneficial move.
- There is some nervousness that there is a difference between comparability and absolute consistency. We need to make sure that we strike the right balance.
- As regards to endorsement, this has to be a European process. Therefore Europeans need to be brought in and consulted. It would be helpful to put ourselves in a position where we are able to update our concept of what is high quality.
- The IFRS system is not perfect, but there no other regime at the moment and it would take a lot of time and effort to find such regime. It is therefore better to work with the system we have and improve it. The endorsement mechanism is very important and we need to make sure that there are good policy standards allowing us to get involved at a very early stage. Cost-benefit analysis and impact assessment is what we have to focus on.

Claes Norberg, **Member of BusinessEurope and Professor of Corporate Law, Uppsala University**

- BusinessEurope supports the use of IFRS. These standards have proven to be beneficial to the global economy by increasing transparency of companies´ financial position and performance, not in the least by increasing comparability and quality of financial information across many jurisdictions.
- If we had to make a comparison to other GAAPs, it is important to highlight that all financial reporting systems have their benefits and costs.
- Before 2005 many Member States had already adapted to IAS. Sweden e.g. since 1989 gradually adapted Swedish GAAP to IAS (in reality translations since 1996) for listed companies.There is no practical alternative to IFRS today and if there is any alternative at all, then it must be US GAAP for multinationals.
- It is quite clear that the benefits of applying IFRS are significantly larger than applying different standards (effectiveness, increased transparency, increased comparability, use of same standard within group, credit ratings, assessing potential acquisitions, improving competitive position for Europe etc).
- Comparing benefits derived from changes in IFRS since 2005 to incremental costs for gathering and publishing information are difficult since assessing the benefits are a highly subjective operation. When making decisions about changes in financial reporting standards (IFRS) an important thing is what approach to take. Instead of trying to come up with grand theoretical solutions it is better to identify what the problem really is and not change more than.
- The worst outcome for companies would be small changes of IFRS with big costs. There is room for improvement regarding effect assessment. As regards to coordination, ESMA seems to be focusing on disclosures, but there is a lot of space for improvement in this area. Businesses in Europe are concerned with this issue, and there are big differences in all member states regarding enforcement, what information is required and what is not. Enforcement coordination is about having proper application of IFRS. Different approaches in Europe might leave an uneven playing field.

Ricardo Sanchez Fernandez, Member of EBF and Head of Supervisory Relationship and Financial Regulation, Bankinter

- To understand the cost of IFRS compliance it is necessary to differentiate between the quality of global standards and the quality of financial reporting. Financial reporting is a domestic requirement for companies and to some extent the quality of financial reporting depends on the importance management places on its reporting responsibilities and whether companies want to comply with the bare minimum or make a concerted effort to produce high quality financial reporting. This is a cost/benefit judgment and will largely determine the cost of IFRS implementation.
- Also we have to keep in mind that judging cost/benefits requires that the IFRS costs are compared to the alternative i.e. local GAAP. For Germany the alternative would had been US GAAP and for other jurisdictions local GAAP would had evolved to provide better and more useful information adapting to new market products and economic circumstances.
- Finally, the bulk of financial reporting cost do not arise from IFRS reporting but from everything else that comes along in the financial statements: capital requirement reporting, local supervisory guidelines, local law regulation, transparency directive, etc.
- On the side of SME, it would be expected that in order to attract investments, they would be best off using IFRS as this is likely to provide more transparency than domestic GAAP. Balance based lending is largely dependent on the entity's ability to generate cash flows. Audited financial statements are the best cover letter to provide information of cash flow generating capacity to the market.
- Also it would be desirable that IFRS Groups are allowed to present their solo and subsidiaries accounts in a consistent GAAP to its consolidated accounts. This is no just a cost efficient issue. It also relates to the fact that companies would be presenting financial information that is comparable and consistent to group accounts. Accordingly, we believe that the scope of IFRS should be modified to allow IFRS group to present its solo and subsidiaries accounts under IFRS or Local GAAP at its own discretion.
- Finally, it would make sense that large unlisted insurers or banking groups are required to move to IFRS. In some countries where this is not the case, these type of entities are required to user a special local GAAP very similar to IFRS. This is the case of Spain, for instance.
- IFRS have been a learning process for everybody. The progress is great and the system can only be improved.

Mark Vaessen, **Chair of the Corporate Reporting Policy Group, FEE**

- In reaction to the debate on benefits, it is important to point out that having one language encourages cross-border mobility of accounting, auditing and finance people, which is an important additional benefit of IFRS.
- Before 2005, 25 national Generally Accepted Accounting Principles (GAAPs) were applied in the EU, and in many countries there was no national enforcement mechanism. Many were turning to the US GAAP by default. Ten years later, most countries show a tremendous improvement in financial reporting. Europe is increasingly achieving a common accounting language.
- There are still inconsistencies and differences across Europe with respect to national enforcement, but overall, enforcement quality has improved in many countries and we are moving towards a more common approach. The recent ESMA guidelines are a useful contribution in this regard.
- ESMA is contributing to bringing the reporting quality to a more consistent level. It is taking a lot of useful actions in order to get to a common enforcement approach (eg, its EECS

discussions and database and its common enforcement priorities). At the same time we have to understand that ESMA has a coordinator role, it is not an enforcer itself and, therefore, there are certain limits to what it can do, in particular in reacting swiftly to emerging issues

- Shortening the endorsement process may be desirable but difficult to achieve, because there are many parties involved in the political process. At the moment they all need to have their say and be consulted, and the endorsement speed very much depends on that. We were pleased to see last year that Mr Maystadt in his report noted that more flexibility in endorsement is not desirable. This must be right as we in Europe want to continue to be committed to global standards. As soon as you open up to more flexibility, you are going away from that objective.
- We should not forget that the primary purpose of financial statements is investor protection and transparency. Therefore we need to be cautious with respect to adding other objectives such a financial stability, which to a large extent is already included in the current objective of "European common good" Rather than changing the endorsement criteria, we have to make sure that Europe's concerns are expressed and addressed early on in the process. The restructured EFRAG plays a crucial role here.

Concluding remarks

Olivier Boutellis Taft, **CEO, FEE**

- Impact assessment (IA) is a good public policy practice. Usually in IA there is much talk about cost – and little about benefits which are often more intangible and more difficult to measure – but should not be forgotten. The panel was very clear in saying that the IFRS benefits outweigh the costs. It is also important to point out that some of these costs are not related to IFRS but indeed to other sources such as local regulation. The important point with IA and with this evaluation in particular is that it should always be objective and independent.
- The IFRS debate should be dispassionate, objective and factual; it should not be hijacked to pursue objectives that are not related to improving transparency and quality of companies' financial information.
- Europe drastically needs growth and jobs: it needs financing i.e. integration of its capital markets; it needs foreign investment and has a large debt to place on financial markets; therefore it needs international standards and benefits from them.
- 10 years ago we were unable to agree on accounting in Europe and it was the right move to outsource the matter to an independent third party: the IASB. Today's debates prove that externalising is still the right thing to do. There is growing realization and consensus that IFRS have improved quality and transparency. The objectives of this EC evaluation therefore appear to be achieved.
- Complexity is mostly inherent to the type of entities and transactions. We should not confuse the cause and the consequence, or shoot the messenger, for instance: IFRS is trying to portray the financial impact of complex financial instruments; it is not "making" these instruments complex. This is not to say that all is fine and nothing should change. Things do change and Europe succeeds in influencing the IASB and the IASB is listening.
- The best approach is to contribute and influence as early as possible. We have EFRAG as a new instrument to do this. Under Mr Maystadt leadership EFRAG has reformed itself and is now more inclusive and more effective. This means Europe may be able to speak with one voice. The EC and EFRAG should be in the driving seat here.

- The EC and the EP can be satisfied that 10 years ago they made the right move. More and more countries follow the EU leadership. They can be satisfied that during this period they have positively influenced the IASB and that we continue progressing on this track. They can be satisfied that Europe has high quality financial reporting contributing to more transparent, more robust and more effective capital markets: and this is critical to the jobs and growth agenda that we are all working for. We need to continue moving forward – not backwards.

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