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change?
Some Longer Term Views on IFRS

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Abstract

The IFRS have been an impressive success story being applied by about 2/3rds of the world. Essentially the US remains outside, at least until further notice as the SEC is planning to make a new move in 2011, while “marking to market” has been announced to be open for a more flexible reading.

The main objective will be to keep the IFRS truly worldwide, what is a valuable public good, but may be difficult to achieve. There is a risk of differences in rulemaking, in interpretation and in application. Strong monitoring will be needed to keep the IFRS identical all over the world.

National differences in accounting rules and interpretation may be due to different needs: shareholder v. creditor protection. This divide also characterizes several company law provisions, and should be overcome.



Financial Reporting and Auditing – A time for change ?

Some Longer Term Views on IFRS.

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The organisers of this conference invited me to reflect on the longer-term challenges of the International Accounting Standards, and the evolutions that lay ahead. Where will we stand with the IAS in about ten to fifteen years time, taking into account the vast changes in the world's economic balance?

Before talking about the challenges, one has to look at the achievements. Indeed, IFRS is an impressive success story, certainly from a historical perspective. From a quite obscure origin, mainly stemming from the needs of the accounting profession, the Standards are now accepted in a very large part of the world, with more than 100 countries subscribing to them and the world most important jurisdictions signing up, such as Japan, for 2012, Russia, but also China and India. In fact about 2/3rds of the world uses these standards. One can also state that the IFRS are considered quality-wise good standards, that represent a good balance between rules and principles, a feature that is often the subject of criticism of the US GAAP as being too detailed. The IFRS respond to the expectation of the globalised world economy, and have contributed significantly to the development of capital markets, mutual confidence, and hence to cross border investment, thereby aiming at a better allocation of means and of capital. Of course, they have some weaknesses, and some compromises were too political to fit well into the overall consistency of the system. Also there is the concern of being too strongly investor oriented, hence the concern of implying short-termism, to which I come back later.

The challenges I see can be identified under four headings:

1. The Global Reach of the IFRS.

Now that a very large part of the world has signed up to, or has given very clear signals that it would adhere to IFRS, the main exception remains the US. A project has for several years been on the agenda to apply IFRS to US listed companies, but was postponed due to the crisis. The agreement to have the two systems convergence², still remains in force, but the crisis has put this agreement under great stress.

Recently, under the chairmanship of Mary Shapiro, the issue is on the table again, and discussions are going on to take what may be a final position in 2011. It would seem that in the meantime, the differences between US GAAP and IFRS are becoming less deep, especially also taking into account the declaration, end of the previous month by Leslie

¹ Presentation at the Hearing organised by the EU Commission, on Financial Reporting and Auditing, on the 9 February 2011, Brussels

² The IASB trustees stated that “convergence is a strategy aimed at promoting and facilitating the adoption of IFRSs, but is not an objective by itself”. (Meeting of 15 2 2011)



Seidman, the new head of FASB that “marking to market” may not be the only or the best interpretation of “fair value” but that “amortised cost” may also meet the markets’ needs for information. This would be a momentous change and observers agree that it would open new avenues for convergence between the two standard setting bodies.

In the meantime, ideas are being developed about the *process of convergence*, whereby one wonders whether the US would outright endorse the IFRS, or rather strive for convergence, opening the way for a US variety of IFRS, etc, what would be very detrimental to the entire project. According to some sources, the process might be that FASB would endorse the already adopted IFRS and on which IASB is not presently working, but at the same time more and stronger US involvement would be planned for new standards that are still under development at IASB³. This would imply that in some form or another FASB would seek a stronger input in developing new standards, raising some issues of governance in the Board including about the US presence in it.

2. Independence of the IAS board

Indeed the present IAS-board is an independent group of 15 experts, to be increased to 16 in 2012, who according to the IASB website present “an appropriate mix of recent practical experience of standard-setting, or of the user, accounting, academic or preparer communities.”. The worldwide application will increase the pressure to have the major economies well represented on the board, what is already largely the case and will ensure worldwide ownership of the common standards. However, one should not go too far in that direction, by imposing different types of specific quota rather than an overall balance, such as detailed rules on nationality or gender: members should not be designated in the basis of their nationality, but on their superior knowledge and understanding of both the technical and wider issues that will be affected by their decisions. Although some people raise concerns about an overrepresentation of the big accountant firms, one cannot do without and provided there is sufficient expertise around the table from other independent experts, that risk can effectively be mitigated. The same applies to the risk of overrepresentation of the Anglo-Saxon professional world, as account should be taken of the strong development of accounting practice in these jurisdictions.

As a consequence of the convergence of the two systems, the possible merger of FASB and IASB has sometimes been mentioned in the US. Is this a real issue? Should it not be approached by ensuring a balanced composition of IASB?

To conclude: there is certainly new hope that significant steps will be taken, even that a decision of principle will be adopted by the SEC adhering to IFRS, at least for the larger US companies. I would say: to be followed... but the last word has certainly not been said.

3. The risk of diversity: One IFRS or several?

The biggest threat to the international worldwide character of the IFRS is the development of local standards, rules, practices, and interpretations. Diversity can occur at different levels, but by way of principle, all should be done to strive for a single system, allowing for use in all

³ Paul A. Sedwick, Deputy Chief Accountant, SEC, Remarks before the 2010 AICPA National Conference on Current SEC and PCAOB Developments <http://www.sec.gov/news/speech/2010/spch120610pab.ht>



countries, developing one single worldwide corpus of concepts, applications and interpretations. Indirect advantages would be the possibility to improve on training, allow preparers, auditors and experts of all sorts to practice all over the world and rely on a broader group of knowledgeable preparers and auditors.

Although the objective is clear, one should not be fanatic about its actual application. Even within one single jurisdiction, the present standard is not always applied in the identical same way by all preparers. The standards are based on a large dose of judgment, reflecting reality over form. Therefore it is important that there would be ample information on the way the standards have been applied in the different jurisdictions. One could best compare it with the development of precedent law by the courts: legal systems – the legal systems once based on the Code Napoleon are a good example – have sometimes the same codes, the same rules, but their applications may differ, allowing judges to borrow solutions from their neighbours, or to reflect their different views and often leading to the same outcomes, even if the reasoning may be different. But the judgments have to state their motives: so for the application of the IFRS.

Diversity can take different forms: in the original state it could be diversity in rulemaking, followed by diversity in interpretation. But more important it seems would be the actual application.

- Diversity in rulemaking

In the first place, the risk of diversity relates to the development of one or several accounting standards. As per hypothesis, one single body will develop the standards, the issue of divergence will arise not at that level, but at the one of interpretation and application. One sees already certain signs, e.g. in the US, distinguishing “endorsement” from “convergence” what I would decode as an euphemism for allowing differences in standard setting or interpretation taking into account local specificities. The issues of coexistence of two types of standards, e.g. one for listed, one for unlisted firms, is not necessarily an element of contradiction, as it was agreed from the beginning that the application of IFRS to unlisted entities – as is still the case in many EU member states - would not be mandated.

Will the introduction of IFRS in the US put an end to US GAAP? The question is a delicate one, and is objected essentially by small firms, as these are not exposed to the international markets, and therefore do not see any reason to adapt a new accounting standard. That would be a dangerous road, as IFRS are supposed to be universal, and many jurisdictions would start to develop separate sets of IFRS. The real solution is probably to develop an “IFRS light” that would allow firms as they grow to fully adopt all IFRS⁴. A clear transition plan will be necessary, also to allow preparers to get acquainted to the IFRS approach that requires more judgment and fewer rules based verifications, and therefore the preparers have to give up some of their comfort.

- Diversity by interpretation.

Today IFRIC is doing – what is generally recognised - interesting, highly valued and indispensable work. However the process is complicated, and the number of issues to be dealt with so massive that one cannot stop the world and actual practice evolving.

⁴ As was alluded to by the IASB trustees” The Constitution will note the need to ‘take account of, as appropriate, the needs of a range of sizes and types of entities in diverse economic settings’ (Meeting of 15 February 2011)



As today, there will also in the future be other sources of interpretation: ESMA has on its website a list of “views” – already 106 have been published - about the views of the national supervisors about the use of IFRS in certain given circumstances. Discussions about interpretation questions are raised in the context of the European Enforcers Co-Ordination Sessions (EECS) resulting in common, but not binding positions. The purpose of this exercise is stated as “to increase convergence amongst enforcers’ activities across Europe”.

But tomorrow there will be other sources of interpretation, active in several parts of the world. It is clear that although these have no binding authority, they will serve as sources of information or rather of “inspiration”, comparable to the case law that is published by the law courts. But there will be a need for coordination between these secondary sources of interpretation, or at least for disclosure of their respective positions, so that the evolution towards a common body of rules can be maintained. The coordination debate at the worldwide level could be a task that could usefully be organised within IOSCO, the worldwide organisation regrouping virtually all of the securities commissions (the “enforcers”) of the world. Indeed with respect to listed companies, these commissions generally are in charge in overseeing the company disclosures, including the monitoring of the financial statements of listed companies. Here again it is the uniformity of IFRS that is at stake.

- Application of the standards

This phase concerns the actual use of IFRS. As the standards become increasingly international, the way they are used inevitably risks diverging, making the comparability of the outcomes hazardous. The usefulness of the worldwide standard would be seriously jeopardised if financial markets and other users would have to mentally restate the financial statement of companies. If that would be the case, one would be better off with the formal restatements, as we still know them today.

Practically, the issue is double: how do the auditors ensure the application of the standards? How do the companies deal with the standards?

The auditors are the lynchpin in the application of the standards: they declare in their formal opinion that the standards have been duly applied. Therefore, if one wants to effectively insure the application of the standards, action has to be addressed to them. The EU 2006 directive on statutory audits introduced a system of “public oversight” whereby national authorities have been designated with the tasks i.a. to develop standards or to oversee quality assurance; they may conduct investigations in relation to statutory audits, and have the right to take appropriate action. However, the cooperation framework among these national authorities is rather weak. Therefore, also taking into account the forthcoming debate on mutual recognition and home country supervision, it would be useful to investigate how this type of oversight can be reinforced, not only at the national level, but also essentially at the European level. According to the methodology that has now been developed with respect to financial supervision, it might be considered to introduce a similar “hub and spoke” system, whereby a European authority, apart from developing regulations in the field of auditors and auditing, would be in charge of supervising the way the national authorities exercise their powers and ensure the level playing field. Peer reviews and monitoring would reveal to what extent the legal obligations, including the effective application of IFRS are met in the national

systems. In principle a two-tier system – whereby actual oversight is exercised by the national body, that is in its turn overseen by the European one – would be preferable, but occasionally direct insight into the accounting treatment in an individual company might be desirable as the eruption of an accounting scandal might put in danger the reputation of the entire profession. It is in this respect that ESMA might play a useful role, as it does already today, through the EECS, whereby the enforcers would identify shortcomings in implementation that could then be reported to the national competent authority for auditor oversight.

There would also be a useful international dimension to this proposal as this new European authority would be the privileged partner in the worldwide dialogue on audit quality. Here again, Europe would definitely be stronger by pulling together all the national positions and express a single European voice.

But beyond these technicalities, the essential point is that instruments have to be developed to guarantee that these standards are effectively applied and in the same way.

4. Addressees of the accounting rules

The fundamental debate about the addressees, the ultimate recipients of the accounting rules cannot be left unmentioned. It is clear that this much-debated question cannot be solved here. But the answer to the question determines the concept underlying the standards. In the first instance the IFRS are addressed to the companies, and to the preparers of the accounts, with the auditors as the external reference and are aimed at ensuring transparency about the assets and liabilities, income and charges for a company.

But ultimately to whom are they addressed: are these only for the financial markets, i.e. the investors, or also for the creditors, the regulatory community – both financial and non-financial - and the wider public interest⁵? And are the standards conceived taking into account only one of these interests – the investors, in the present standards – or should they also consider other interests? The discussion has been on the table since many years and no easy nor satisfactory solution has been found. The most recent point of conflict turned around some aspects of the fair value and “marking-to-market” principle in the financial sector, where the two schools have been presenting contradictory arguments, at the end coming forward with a wishy-washy solution. Maybe that the more flexible attitude of the US on “marking-to-market” will be the first sign of an easier dialogue between these two tendencies and open the way for a more balanced long-term solution.

But rather than trying to find an answer to this question, it might be useful to turn to the deeper reasons why these opposing views are adopted. The basic point seems to be that they serve different needs: for trading houses, like investment banks, all assets should be kept at market value as they are continuously engaged in trading, for other banks where assets are held in a long term perspective, often until maturity, a modified form of historic value would be more satisfactory. This difference goes straight to the core of our economic systems.

It is well known that there is a considerable difference between the financing systems in the US and Continental Europe, as the former is more market financed, while the latter is more bank financed. The differences are roughly $\frac{3}{4}$ to $\frac{1}{4}$ and 80 to 20. The way these different

⁵ Recently the IASB trustees, in their meeting of 15 February 2011, confirmed that “The new Constitution specifically identifies investors as a target audience for financial information (in addition to other participants in the world’s capital markets and other users of financial information)”



parties look at the accounts will not astonish: creditors have a limited interest and their main if not only concern is to see their claim repaid, while markets and especially shareholders want to be as close as possible to the market value, the price at which the assets can be sold or bought which determines their decision to buy or sell. The difference also explains at least to a certain extent, the divergent approaches of FASB and IASB. This difference is found back in many other aspects of the regulatory regime, such as company law. Take e.g. the rules on capital as laid down in the Second EU Directive, that are mainly directed at protecting creditors. Some will rightly argue that that directive also contains provisions to protect shareholders – e.g. on preferential subscription rights -, but I would classify these as minority protection rules, using capital as a yardstick, not as directed to capital as such. Most of these concepts are unknown in the US, where creditors and shareholders are protected by different techniques, such as fraudulent trading or equitable subordination, but not using the notion of capital. A similar observation can be made about the mandatory publication of financial statements, mandatory for all companies in several EU states, not heard of in the US. The well known divide between the approach of the prudential supervisors and the accounting standard setters, closer to the market will therefore not astonish: it is the expression between to different financial or economic systems. It also illustrates how difficult it will be to bridge the two views.

It seems clear that the use of fair value accounting will continue for some time to be at the core of the debate. I will not offer an answer to this crucial question, which has kept standard setters busy for quite some time, and even created deep divisions. The welcome statements by the new chair of the IASB, Hans Hoogervorst⁶, create new hopes in this respect. Therefore, bridges have to be built between the two approaches. I may hope that the IASB, and its new chair will be able to find the right solution.

⁶ See his speech: The objectives of financial reporting, Speech , Brussels 9 February 2011.

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The **Financial Law Institute** is a research and teaching unit within the Law School of the University of Ghent, Belgium. The research activities undertaken within the Institute focus on various issues of company and financial law, including private and public law of banking, capital markets regulation, company law and corporate governance.

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