

Assessing the role of IFRS in building stronger European Capital Markets

EFRAG Conference - IFRS & Regulation: Searching for Common
Ground

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Good afternoon Ladies and Gentlemen,

I am pleased to have the opportunity to give a key-note speech this afternoon and I would like to thank EFRAG and its President, Jean-Paul Gauzès, for inviting me.

Setting the scene: IFRS and EU capital markets

This year marks the tenth anniversary of two important events that are linked to the theme of today's conference and that illustrate well the interaction between public authorities and IFRS.

On the one hand, the establishment in January 2009 of the Monitoring Board with the task of reviewing and providing advice to the IFRS

Foundation's Trustees, formally created a link between the Foundation and public authorities, including securities regulators and the European Commission.

On the other hand, the publication in February of the same year of the De Larosière report based on which, not only ESMA was established, but also the foundations were laid of the debate on the role of mark-to-market accounting in the financial crisis and to what extent it supports long-term investment. These themes have at times generated strong, and from my perspective, unjustified criticism of IFRS and their ability to serve the European public interest.

These initiatives, coupled with more recent ones, such as the resolutions of the European Parliament calling for a thorough assessment of IFRS 9 *Financial Instruments* and IFRS 17 *Insurance Contracts*, reflect the increasing scrutiny of public institutions on IFRS. This public scrutiny can ultimately be related to the same underlying question: “*Are IFRS still well-suited to serve European capital markets?*”.

In my remarks today I will explain why I believe that this is the case from ESMA's perspective by considering three aspects: first, the strong relationship between IFRS and building a Capital Markets Union; second, the role of IFRS in enabling effective accounting enforcement; and third, the role of IFRS in facing the upcoming challenges and opportunities arising from electronic reporting and sustainability.

IFRS for a stronger Capital Markets Union

Let me start by explaining why I believe that IFRS can be a major contributor to strengthening the Capital Markets Union. IFRS, due to their focus on meeting the needs of users of financial information, have the potential to enable efficient capital allocation which is an important pillar of well-functioning capital markets. This also explains the long-standing collaboration between ESMA and the IFRS Foundation which is rooted in the acknowledgement that high-quality accounting standards, issued via an independent process and effectively enforced, are a necessary premise to promote orderly markets, investor protection and, ultimately, financial stability.

In this respect, let me say how delighted I am to see Michel Prada here, with whom, as Chair of the Trustees of the IFRS Foundation, we built a successful working relationship between ESMA and the Foundation. Which continues today under the chairmanship of Erkki Liikanen.

In my view, the strong capital market orientation of IFRS can be an important factor in building a stronger Capital Markets Union. In order to ensure, and facilitate, broader investor participation in EU capital markets, we need to have a strong equity culture in which the financial reporting system responds to investor demands.

IFRS and EU accounting enforcement

Let me now move to how IFRS have contributed to effective enforcement and continue to do so.

Since 2011, ESMA – and before then its predecessor body, CESR – has

promoted convergence of supervisory practices in the accounting domain by coordinating the supervision and enforcement of IFRS across the European Union.

As we know from academic research, the potential of IFRS for fostering investor confidence and transparency in financial markets can only materialise if the institutional context in which IFRS are applied is conducive to high-quality reporting. This includes the need to have an effective enforcement system in place. Consistent with that premise, in 2002 EU co-legislators explained in the IAS Regulation that the introduction of IFRS should take place in combination with efforts to achieve stronger supervisory convergence in the EU.

On the basis of ESMA's long-standing experience, I can say that EU supervisory convergence has been well served by IFRS.

First, the principles-based nature of IFRS offers a suitable basis for adapting to the inevitable variety of facts that occur in the reality of business in a diverse jurisdiction such as the EU, while still enabling a sound and consistent approach to both implementation and enforcement. This is one of its key benefits for such diverse jurisdiction.

However, this combination of flexibility and rigour that is built into IFRS comes with the inevitable cost of leaving some room for interpretation to both issuers and enforcers. *How should we then deal with the possibility of various interpretations that IFRS create?*

ESMA's experience shows that when enforcement cases are collectively discussed by national authorities and fact patterns are assessed in their entirety, even if the application of IFRS may not always be straightforward,

the outcome of such extensive discussions is generally a converged position on how IFRS should be applied to the specific circumstances.

However, if there still is a lack of clarity in the reading of IFRS, ESMA submits a request to the IFRS Interpretations Committee which would then either clarify the matter by issuing an agenda decision or an interpretation, or revert back to the IASB for standard-setting.

As you will understand, ESMA does not support the issuance of national or regional implementation guidance for IFRS, not only because it would be contrary to the IAS Regulation, but also because it would be potentially detrimental for the much-needed EU-wide consistent application of IFRS. Furthermore, EU or national specific solutions weaken our position as a single, cohesive jurisdiction and makes it less influential in the accounting debate at global level.

Obviously, if local jurisdictions resist the temptation of issuing IFRS implementation guidance, the responsiveness of the IFRS Interpretations Committee (IFRS IC) and the IASB must ensure timely solutions to the problems identified. In this respect, agenda decisions represent a suitable basis to provide clarifications on the application of IFRS, including when they depict the *thought process* that issuers are expected to follow in conducting the accounting analysis for complex transactions, as recent agenda decisions on IFRS 15 *Revenue from Contracts with Customers* have shown.

However, it is important to avoid that agenda decisions – or other forms of *educational material* issued by the IASB – result in new requirements which would then be difficult to enforce given that their source is not an

endorsed IFRS or interpretation.

However, I should also admit that the principles-based nature of IFRS may sometimes make our enforcement work more challenging. In fact, depending on the national enforcement systems, the reliance on principles instead of more prescriptive requirements, may make it difficult for enforcers to take action and challenge issuers' practices.

This is why it is important that disclosure objectives are clearly articulated and coordinated with more granular disclosure requirements in order to assist enforcers in challenging the practices of issuers that may *tick-the-box* and comply with the detailed disclosure requirements, but still fall short of providing sufficient information to meet a specific disclosure objective.

A second aspect by which IFRS contribute to effective enforcement is linked to their ability to provide accounting conventions that fairly reflect the underlying economic reality of the business while avoiding excessive complexity. As enforcement is not limited to a binary compliance exercise, but also requires assessing the quality of the information reported vis-à-vis the underlying economic substance of economic transactions, this feature of IFRS is particularly important when enforcers assess whether the information reported properly informs investors.

Let me give one example regarding the treatment of equity instruments in IFRS 9. This issue has recently attracted much debate in accounting fora, also thanks to two requests for advice issued by the European Commission to EFRAG.

The predecessor standard of IFRS 9, IAS 39, provided a principle for the impairment of equities classified as available-for-sale (AFS), with a set of

indicators to implement that principle. ESMA's research and experience of European enforcers indicated that this approach was complex and led to significant divergence in practice. Academic research also showed that the use of the AFS category allowed for opportunistic profit-taking behaviour by some issuers which, in some cases, were contrary to the alleged intention to hold the equities as strategic or long-term investments.

Subsequent attempts by the IASB to reinforce this principle and to explore potential *rules* did not succeed and ultimately the IASB decided to develop a different convention – i.e. the classification at fair value through Other Comprehensive Income (OCI) with no-recycling – which is still debated today.

I will not explain – as we have done so publicly several times also here at EFRAG – why we believe that this was the right decision from the perspective of investor protection and to provide a better depiction of the performance of equities held by issuers, including those held for the long-term.

Upcoming challenges and opportunities arising from electronic reporting and sustainability

Let me now move to the opportunities and challenges posed by electronic reporting and sustainability and what role IFRS can play in these developments.

Let's project ourselves in the very near future where the considerations that I have developed in relation to the enforcement of IFRS will occur on the basis of electronic reports prepared according to the European Single Electronic Format, or ESEF.

As you may all know by now, starting from the reporting period 2020, the ESEF Regulation requires issuers to present their consolidated financial statements in Inline XBRL format. For the first two reporting periods, the obligation will cover only the *face financials* included in the primary statements – Statement of Comprehensive Income, Statement of Financial Position, Cash Flow Statement and Statement of Changes in Equity – to then extend to the entire financial statements, including the notes, by 2022.

The existence of a complete and well developed IFRS Taxonomy was essential for ESMA in developing the ESEF. The availability of ESEF financial statements will open up new opportunities for users, investors and accounting enforcers thanks to the improved usability of reported information. At the same time, ESEF will also allow a clearer and more immediate understanding of how the source data from issuers have been compiled by data aggregators, thus improving the quality and consistency of the data provided by these platforms. The quantity and quality of available data relating to Small and Medium Enterprises (SMEs) from data aggregators will also potentially improve without requiring massive efforts, thanks to the availability of the source data directly from the issuers' ESEF financial statements.

For accounting enforcers, the availability of financial information in a structured format will facilitate the analysis of information reported by issuers, although I do not expect enforcers to move towards 'robo-enforcement'. Certainly automation enabled by structured data and coupled with technologies relying on artificial intelligence will enable faster comparisons across issuers and, for the same issuer, across different

reporting periods. Such efficiency gains will allow for the timely identification of any discrepancies and risk factors – such as for financial distress as already occurs in Denmark today – which may feed the selection procedures of enforcers and give rise to further and more-in-depth assessment by national authorities. The introduction of the ESEF will also help national authorities reduce the risks and time-consuming efforts associated with manual processing of massive amounts of data.

From ESMA's perspective, the availability of data in ESEF format will potentially enable more effective and timely thematic reviews on accounting topics as well as assist the annual process of identifying topical issues to include in our enforcement priorities.

In a nutshell, thanks to the availability of a single taxonomy, moving into electronic reporting will further amplify the benefits of harmonisation under IFRS as set out in the IAS Regulation by helping rationalise the diverse presentation and reporting practices. At the same time, the use of a single taxonomy will still preserve the flexibility permitted by IFRS, by allowing ad hoc extensions to the core ESEF taxonomy. We expect that further benefits in terms of rationalisation of the presentation practices will arise thanks to the forthcoming proposals on the IASB's project on the Primary Financial Statements.

If electronic reporting projects us into the digital age, another key question is what role corporate reporting and IFRS can play in the context of sustainability. I think that this is an area where we are accustomed to looking at financial information prepared in accordance with IFRS and non-financial information as two separate information silos.

However, when thinking about the complex and inextricable nature of business operations, they occur in a multi-stakeholder environment and they are affected by factors – and give rise to effects – which, in part only, can immediately and relatively easily be described in the form of monetary items and financial trends.

This leads me to two main considerations. First, to continue being relevant, IFRS need to consider how future projections – which are already required to be made, for example, in impairment calculations – need to take into account risks arising from aspects relating to sustainability risks and opportunities. If an issuer is exposed to the risk of stranded assets it cannot continue to account for them as if such risks do not exist. I think IFRS already include principles that cater for such forward-looking considerations, but perhaps a closer look into this matter may be useful to raise awareness amongst IFRS adopters and users of IFRS information.

Second, we need to acknowledge that there are a number of economic realities that are not well suited to be recognised via the double entry system of accounting which are nevertheless increasingly important. Investors request more and more transparency on ESG disclosures and issuers still seem to struggle to close this expectation gap. The result is a significant risk of exposing investors and other market participants to greenwashing practices. To respond to the increasing, and genuine, demands from the investor community for reliable ESG disclosures we can learn a lot here from the success story of IFRS reporting in Europe. ESMA stands ready to support the European Commission to take further steps into this direction.

Conclusion

Ladies and Gentlemen, let me conclude.

Looking ahead at the future development of corporate reporting in the broader scheme of stronger EU financial markets, I strongly believe that IFRS should remain focused on depicting economic reality in a neutral way. To do so, it is also important to ensure that an independent governance process oversees both the development and the endorsement of IFRS. I think that this is the best way to ensure that IFRS contribute to supporting long-term investment and the shift towards a more sustainable financial system.

At the same time, we have to acknowledge that IFRS information – although it remains important – only tells part of the story. It is therefore necessary to bring non-financial information to a level of maturity that is comparable to that of IFRS information and achieve more transparency on non-financial information to complement IFRS financial statements. This will enable investors and other stakeholders to further assess the potential for value creation of issuers.

To help this process, it is urgent to update the Non-Financial Reporting Directive to complement it with binding measures that specify, in more detail, principles and requirements for the preparation of non-financial disclosures.

Only by integrating financial and non-financial information will we ensure that not only IFRS, but, in general, corporate reporting continues to be well suited to support stronger European capital markets.

Thank you.