IASB and IFRS Foundation chairmen urge constituents to respond to European Commission consultation

Chair of the International Accounting Standards Board Hans Hoogervorst and Chair of the IFRS Foundation Trustees Michel Prada respond to the European Commission consultation on Fitness Check on the EU Framework for Public Reporting by Companies.

On 21 March 2018, the European Commission (EC) published for public comment a questionnaire seeking feedback on the European Union (EU) framework for public reporting by companies, with a comment period open until 21 July 2018.

One of the most important questions asked in the questionnaire of the Fitness Check is whether the EU should introduce a mechanism to allow changes to be made to IFRS Standards as used in the EU, known as 'carve-ins'. This would be in addition to the EU's existing (and rarely used) powers to choose not to endorse an IFRS Standard or parts of it, known as 'carve-outs'.

It is, of course, for each jurisdiction to determine whether and how to incorporate IFRS Standards into its accounting requirements. However, the fact that the questionnaire repeatedly raises the possibility of introducing European carve-ins to IFRS Standards has surprised us for several reasons.

First, for more than 20 years the EU has been the main driving force behind the G20-endorsed goal of a single set of high-quality, global accounting standards. It is not clear why the EU would consider departing from this goal at a time when the EU is rightly concerned about global economic standards being under tremendous pressure more generally.

Second, the EU has—on two occasions in the last five years—sought feedback on the possibility of introducing a carve-in mechanism to the EU endorsement process, with both reviews cautioning against such a change.

The 2013 Maystadt Review concluded that introducing carve-ins to create EU-adapted IFRS Standards risked:

1. encouraging the creation of regional, rather than global standards;
2. increasing the cost of capital and reporting for European issuers; and
3. exacerbating excessive lobbying for private interests up to the last stage of the endorsement procedure.

The Maystadt Review also noted that 'developing a European version of IFRS Standards could prove counterproductive regarding achieving more influence over the IASB.' According to Accountancy Europe (previously FEE), a 'binary yes or no endorsement seems to bring more powerful dissuasion than opening the possibility of modifying a standard: the IASB might be less inclined to take Europe's concerns into account if Europe can freely modify the standard itself.'

The 2015 European Commission evaluation of a decade of IFRS Standards confirmed the conclusions of the Maystadt review: 'The Maystadt report stated that caution is necessary in this area and most stakeholders supported maintaining the status quo.'

It is not clear what new information has come to light since these two evaluations were completed, for the discussion about a European carve-in to be reopened so soon.

Third, the Fitness Check questionnaire implies that the EU is an outlier in adopting IFRS Standards without modification. Our analysis shows that 144 jurisdictions require the use of IFRS Standards for all or most publicly listed companies. These jurisdictions include three quarters of the G20 and the combined GDP of IFRS adopting jurisdictions is greater than the non-adopting part of the world.

Of the 144 adopters, 87 jurisdictions have no endorsement mechanism at all and simply adopt IFRS Standards as issued by the IASB. The remaining jurisdictions have endorsement mechanisms in place, of varying levels of complexity. The EU's endorsement process is already the most elaborate of all. As mentioned in the Maystadt Review, it ensures that the EU is highly influential at every level of the IASB's standard-setting process and committees.

The Fitness Check mentions that several large jurisdictions have not fully adopted IFRS Standards. That is true, but a closer look at the United States, Japan, China and India gives some interesting information about the significance of unmodified IFRS Standards within these jurisdictions.

The only major jurisdiction that has no current trajectory for adoption of IFRS Standards is the United States. However, the US allows the use of unmodified IFRS Standards for foreign issuers on the American markets. Introduction of European carve-ins would mean that European companies listing in the United States would, as was the case before 2007, become subject to reconciliation.

In Japan, companies can voluntarily adopt full, unmodified IFRS Standards, but they can also opt for Japanese amended IFRS standards (similar to that being suggested in the Fitness Check). Currently, not a single Japanese company has elected to use the Japanese amended IFRS Standards. Instead, about 170 Japanese companies, representing approximately 30% of Japanese market capitalisation, have chosen unmodified IFRS Standards. The three main reasons cited for using unmodified IFRS Standards are:

1. efficiency in business management;
2. enhanced comparability with international competitors; and
3. better communication with international investors.

China has local accounting standards that are substantially converged with IFRS Standards. China has adopted unmodified versions of all recent IFRS standards and is committed to full convergence with IFRS Standards over time. Moreover, Chinese companies representing around 30% of the total market capitalisation of mainland China also produce financial statements fully compliant with IFRS Standards for the purpose of their dual listings in Hong Kong. Even though these dual-listed companies also have the option to use Chinese Accounting Standards, the vast majority use IFRS Standards for the same reasons as Japanese companies.

India has recently adopted a local variant of IFRS Standards with approximately seven carve-outs/carve-ins. However, Indian authorities are aware that this limits the international recognition of Indian standards and are therefore committed, like the Chinese, to achieving full convergence over time.

The Fitness Check questionnaire suggests that Europe might want to introduce carve-ins to reach a level playing field with jurisdictions like India and China. Would the EU really want to backtrack from full IFRS adoption to a position that these countries do not see as an ideal end state, while individual companies avoid local variants of IFRS Standards wherever they can?

In conclusion, as the Maystadt Review warns, introducing the ability for the EU endorsement process to change IFRS Standards has the potential to open a Pandora's Box of carve-ins, with significant consequences for EU companies, investors and regulators.

In this respect it is also important to note that the Fitness Check questionnaire raises the possibility of adding two new criteria to the EU-endorsement process, namely 'long-term investment' and 'sustainability'. While we applaud the EU's efforts to achieve such goals, the possible impact of accounting standards should not be overestimated, since accounting is primarily a tool to present as fairly as possible economic reality. Promoting long-term investment requires more fundamental policy tools such as adequate asset-liability management and the availability of adequate sources of long-term equity and debt.

Moreover, criteria such as sustainability and long-term finance are sufficiently vague to provide legitimacy for myriad lobbying efforts. If the EU also introduces a European Conceptual Framework, an idea which is tested in the questionnaire, divergence from international norms would almost be guaranteed.

Again, we completely accept that it is up to the EU to adopt accounting standards as it sees fit. But we believe that the introduction of EU carve-ins to IFRS Standards is in many ways a solution looking for a problem. There is no compelling evidence to show why it is needed, while the costs to EU companies—adding accounting friction to European capital markets—would undoubtedly exceed the benefits, the opposite of what the European Capital Markets Union project has set out to achieve.

We strongly urge our constituents to respond to the questionnaire.

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