29 June 2017

IASB Chairman's speech: IFRS 17 and its contribution to financial stability

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In his opening speech at the IFRS Foundation's conference in Amsterdam, Chairman of the International Accounting Standards Board (Board) Hans Hoogervorst talked about the role of accounting standards in fostering financial stability; the new insurance contracts Standard—IFRS 17; and the Board's work to make financial reports a better communication tool between companies and investors.

Introduction

Welcome to our IFRS Conference in Amsterdam. I hope you will enjoy your stay in this historical town, which I, as a Dutchman, of course know very well. In fact, I lived here 40 years ago, studying history at the University of Amsterdam. At the time, I was blissfully unaware that a long and winding career path would bring me to the International Accounting Standards Board and back to Amsterdam many years later…

We should have the ingredients for a very interesting couple of days. We have 300 participants from all over the world, six IASB Members, our senior staff and some great guests from the world of regulation and accounting. We will be discussing the IFRS Standards we recently completed and the new work streams that keep the IASB busy. We will also discuss the broader context of wider corporate reporting.

In my introductory presentation I would like to discuss three main themes:

First I will talk about the role of accounting standards in fostering financial stability. This issue is directly connected to my second topic—IFRS 17, our recently issued Standard on insurance contracts. I will devote the last part of my speech to our current work stream, Better Communication in Financial Reporting, which aims to improve the communication effectiveness of financial reports.

Accounting and financial stability

I would first like to discuss the role of accounting in fostering financial stability.

The International Accounting Standards Board (Board) refers explicitly to financial stability in its Mission Statement. Our primary goal is to develop IFRS Standards that bring transparency, accountability and efficiency to financial markets around the world. Yet we believe that in doing so, we foster not only trust and growth, but also support the long-term financial stability of the global economy.

Some have raised eyebrows at this part of our mission statement. I understand that, because fostering financial stability is obviously not the primary goal of accounting standards. It is primarily the remit of prudential regulators, whose task it is to safeguard the solvency of the financial system.

Still, we are convinced that the transparency delivered by accounting standards is a crucial ingredient for achieving financial stability. Proper accounting shines light on risks that might otherwise go unnoticed—both by companies themselves and by investors. Companies were much better able to manage their pension commitments when IFRS Standards brought pension liabilities to the balance sheet. High-quality accounting gives timely information on onerous contracts, loan losses and the true extent of leverage on the balance sheet.

High-quality standards also result in better insights into a company's performance. They should lead to a faithful portrayal of revenue and do not allow for aggressive recognition practices. High-quality accounting should also prevent that a deterioration in profitability is masked by the release of cookie-jar reserves or by the selective sale of profitable financial instruments. Where volatility reflects economic reality, the accounting needs to show it. Fake stability based on smoothing of earnings ultimately leads to much bigger volatility when reality can no longer be masked. Fake stability is therefore just as bad as fake news!

High-quality accounting is a key underpinning of financial stability because it enables managers to redress problems in a timely fashion. Obviously, it is even more important to investors. Proper financial information prevents investors from pouring good money after bad. The transparency provided by accounting also has a preventative effect. The likelihood of problems being revealed quickly will discourage managers from taking unnecessary risk.

In sum, high-quality accounting serves like the proverbial famous canary in the coal mine. It provides an early warning system to detect changes in the company's risks and its performance.

In recent years, we have done a lot of work to strengthen this early warning system. I already mentioned our work on pension accounting. IFRS 9, our financial instruments Standard, requires companies to provide more forward-looking information about loan losses. IFRS 16,

Our leases Standard, provides better information about lease obligations that previously remained off-balance sheet.

IFRS 17—key features

One month ago, our Board issued IFRS 17, the first truly international standard for insurance contracts. I will later explain why I strongly believe that this Standard will also contribute to financial stability. But allow me to first make some general remarks about this important Standard.

IFRS 17 is the last of the so-called big four—revenue recognition, financial instruments, leases and now insurance. The Board and its predecessor body, the International Accounting Standards Committee (IASC), worked on this Standard for no less than 20 years, but I believe it was entirely worth the wait.

With over $13 trillion in assets, the insurance industry is obviously a hugely important component of the global economy. It is, therefore, unsatisfactory that until last month we did not have a truly international standard for insurance accounting. The current standard, IFRS 4, is no more than an interim measure. In essence, it allows insurance companies to continue to use existing national standards. Many of these standards have not been modernised over the years and they differ greatly from each other.

IFRS 4 truly allows a mixed bag of national standards to be applied to insurance. The top 20 listed insurance companies use a variety of national generally accepted accounting principles (GAAPs). Quite a few multinational insurance companies even consolidate their results using different national GAAPs *within* their financial statements! The differences among these national standards are enormous.

Let’s just look at the way the insurance liability is measured. For the measurement of long-term liabilities it matters greatly which discount rate is used. Among the 100 biggest insurers, 35% still use historical rates, 43% use current rates and 22% use a mixture of rates.

Many national GAAPs result in historical cost information that may have little relevance. Discounting an insurance liability using an interest rate of 20 years ago, when the interest rate environment was completely different, does not provide relevant information. Also, historical cost does not give proper information on the costs of options and guarantees that are often embedded in life insurance contracts. Those costs are often recognised very late or only when they are due. As a result, the accounting often provides inadequate information about the risks to which an insurer is exposed.

There are also big differences in how revenue and profits are recognised. In some national GAAPs, customer deposits for asset management services are recognised as revenue. In others, revenue is recognised on a cash basis, irrespective of the timing of the service rendered. In some GAAPs, profits are recognised up-front, on day one, even when the underlying contract has a long term with an uncertain future. In addition, there are no consistent principles for loss recognition of onerous contracts. In many GAAPs, onerous groups of contracts can be grouped with more profitable contracts, thus these contracts' risk remain invisible to the investor.

Clearly, some of the features of national insurance GAAPs are different from the general principles of revenue recognition and other general IFRS requirements. Few of these divergences can be justified by the specific business model of insurance.

This diversity leads to a lack of comparability. It shows a real-life insurance company that uses one national GAAP as the subsidiary of a group, while using another GAAP for regulatory purposes. As you can see, the same company shows big differences—25% to 60% in revenue, operating income and equity—depending on the accounting language it uses. Even for those who know that accounting is not a simple manner of adding and subtracting, this divergence in outcomes is quite astounding.

IFRS 17 will put an end to this very unsatisfactory situation. It will require current valuation of all insurance liabilities based on uniform principles. The Standard will bring clear principles for revenue and profit recognition, making the insurance industry better comparable to other financial companies, such as banks and asset managers.

IFRS 17's contribution to financial stability

Let me now come back to the issue of accounting and financial stability. As I indicated before, I am convinced that IFRS 17 will contribute to prudence and financial stability. The Standard will provide much more insight in the risks to which an insurance company is exposed.

First of all, the insurance liability will be properly measured and regularly updated, giving much better information. The build-up of unsustainable equity positions will become visible much more quickly.

Second, the cost of options and guarantees will be regularly updated and fully reflected in the financial statements.

Third, companies will also provide updated information on the risk margin they hold for their insurance products.

Fourth, the losses embedded in onerous groups of contracts will have to be recognised immediately. Contracts can be grouped, but in a way that ensures that the losses embedded in onerous groups of contracts will not be averaged with groups of profitable contracts.

Fifth, IFRS 17 ends up-front profit taking and revenue will only be recognised as the service is provided.

Finally, IFRS 17 will also make it easier for investors to judge the performance of any insurance company. Currently, many investors base their analysis on Solvency II, which is the prudential standard for the European Union. But Solvency II is almost entirely focused on the balance sheet. It makes no distinction between profits earned in the past and profits to be earned in the future. It does not convey information about profitability over time.

IFRS 17 will result in better information about profitability trends. We understand that insurance is all about averaging risks; our Standard therefore allows grouping of contracts. This is different from our requirements for other business activities, where generally we require the individual contract to be the unit of account.

Yet, IFRS 17 does not allow unfettered averaging between different generations of contracts. The commingling of different generations of contracts can lead to accelerated or delayed earnings recognition. Delayed earnings recognition can potentially result in contracts contributing to profits long after they have expired! So unfettered averaging of contracts makes it much harder for investors to discern earnings trends. This is why IFRS 17 puts some discipline around the grouping of insurance contracts.

Some insurers do not like these restrictions in IFRS 17. In their current business models, they often compensate for relatively unprofitable contracts with newer generations of more profitable contracts. They see this practice as a unique feature of the insurance business. However, the question is whether this business model is truly so different from many non-insurance businesses.

Many businesses regularly go through lean years of meagre profits. They hope to make up for this in the future with a more profitable generation of contracts in the upswing of the business cycle. Yet IFRS 15, our revenue Standard, does not allow companies to average different generations of contracts. It would make it very difficult for investors to properly analyse earnings trends.

Earnings trends are often an early warning system of problems to come. If we want accounting to perform its function as the proverbial canary in the coal mine, it is important to avoid excessive averaging, even in a business where averaging of risks is an essential part of the business model.

All in all, I believe IFRS 17 to be a huge step forward in accounting and it will bring much needed transparency in this very important part of the economy.

Better Communication in Financial Reporting

With the completion of the new insurance contracts Standard, our Board will have filled most (but not all) of the gaps in our suite of Standards.

So that begs the question, what's next? Well, rather than developing, yet again, major cross-cutting Standards, in the next couple of years we will try to focus more on improving what is already there. We feel we can do more to improve the communication effectiveness of the financial statements. For that reason, we have decided to make Better Communication the central theme of our new work plan.

A couple of issues need to be addressed. Investors often tell us that, currently, financial reporting does not depict the performance of a company clearly enough. They notice that we define revenue and profit or loss, but not too much in between. As a result, there is very little comparability above the bottom-line. Investors therefore want more disaggregation, additional line items and possibly new subtotals that tell more about a company's performance.

Companies, on the other hand, tend to look at the financial statements as too much of a compliance exercise. They often feel they are drowning in disclosure requirements that do not always add sufficient value.

We also see increasing use of non-IFRS or alternative performance measures, also known as non-GAAP, that tend to dominate press releases and investor information packs. Let me make clear that we do not intend to ban alternative performance measures, because some of them

clearly have added value. Yet, we share the concern of many regulators that non-GAAP generally paints a rosier picture of a company's performance than using IFRS Standards would do.

Also, non-GAAP creates a lack of comparability; every company provides in its own alternative financial measures. Such variability is not always in investors' interest. It would be good if we could provide some more discipline and guidance.

So, what can our Board do?

The central part of the Better Communication theme will be to take a fresh look at the Primary Financial Statements—what we call performance reporting. We will have to provide more and better structure to the income statement and the cash flow statement. We will look at the need for new line-items and possibly at subtotals.

Currently, investors tend to analyse the financial statements along two main axes. The first axis roughly distinguishes between operating income and finance activities. This is the main reason the non-GAAP measure Earnings before Interest and Tax (EBIT) is currently very commonly used. The second main axis serves to measure the degree of earnings persistence, which is important for estimating future cash flows. This is the main reason why non-GAAP measures that adjust for infrequent income components are widely used.

Our Board is currently investigating whether it is possible to find principle-based definitions for these commonly used subtotals. It is an incredibly complicated challenge for which precise solutions are not available. But if we can succeed in developing more discipline and guidance around such subtotals, we believe it would help the investor community.

The end result should be better formatted primary financial statements, which increases comparability and makes it easier for regulators to enforce discipline around the presentation of non-GAAP measures.

We are continuing our work on making disclosures more effective. We have already made some changes to IAS 1, our presentation Standard, which make it clearer that companies can remove disclosures that they judge immaterial. Following up on this work, we will soon publish what we call a Practice Statement to help companies apply the concept of materiality. A Practice Statement is non-mandatory, but it is developed using the due process we use for Standards—with public consultations and discussions at public Board meetings.

We hope this guidance will work as a catalyst, moving companies away from treating the disclosure requirements in the financial statements as a checklist. We hope companies will be braver and safer while making materiality judgements. Obviously, companies alone cannot instil this change. It will require collaborative efforts. Companies, auditors and regulators all have to pull in the same direction.

Close

As I hopefully made clear in my speech, we have still a lot of work to do to improve the effectiveness of financial reporting. In addition, we are looking at the question of wider corporate reporting. Much of the value of a company consists of intangibles not captured in the financial statements. Investors have an increasing need for non-financial information,

often related to questions of sustainability. The question is whether the Board should be doing more work in this area, which transcends financial reporting in its narrow sense.

We will have a panel discussion on these questions tomorrow, so I will not elaborate here. But I am especially happy that in one hour we will be able to listen to a key-note address by the Dutch former Prime Minister Jan Peter Balkenende. He is a specialist in governance and corporate social responsibility, so I am very much looking forward to hearing his view on wider corporate reporting.

All told, I believe we have an interesting programme for you over the next two days, discussing our Board's recent work; I hope you will have a fruitful conference.