Dialogue with the IASB

The International Accounting Standards Board (IASB) develops International Financial Reporting Standards (IFRS) used in over 125 countries around the globe. After publishing four major new standards—on revenue recognition, financial instruments, leases, and insurance—since 2014, the organization is now considering its role in other issues, such as the effectiveness of the overall disclosure regime and the expanding use of non-GAAP (generally accepted accounting principles) measures and non-financial reporting.

On November 15, 2017, members of the European Audit Committee Leadership Network (EACLN) met with Hans Hoogervorst, the chair of the IASB. Mr. Hoogervorst, a former chair of the Netherlands Authority for the Financial Markets, has served as the IASB chair since 2011. His current term ends in 2021. *For a biography of Mr. Hoogervorst, see Appendix 1, on page 10. For a full list of participants, see Appendix 2, on page 11.*

Executive summary

Mr. Hoogervorst and EACLN members[1] discussed both the IASB as an organization and some of the specific issues and objectives on its current agenda:

- **The IASB's structure and process** *(page 2)*

  The IASB is a private body consisting of members with diverse expertise and geographical backgrounds. Its standard-setting process is designed to be transparent and inclusive, encouraging input from a variety of stakeholders. The costs and benefits of implementing new standards are key considerations, though Mr. Hoogervorst acknowledged that the benefits can be hard to quantify precisely.

- **The IASB's current focus on better communication in financial reporting** *(page 4)*

  The IASB is currently focusing on making financial communications more effective and meaningful. It is reviewing the structure and content of the primary financial statements and has finalized a practice statement on materiality judgements. In addition, it is digesting comments on improving disclosure principles. Clarity and simplicity are important objectives, but Mr. Hoogervorst observed that the complex realities of business today ultimately require corresponding complexity in financial reporting.

- **Non-GAAP metrics and other alternative performance measures** *(page 6)*

  Mr. Hoogervorst and EACLN members addressed the value and pitfalls of the non-GAAP metrics companies use to supplement GAAP reporting, noting that while often appreciated by stakeholders, some metrics may obscure rather than clarify. While the IASB might be able to provide more guidance, Mr. Hoogervorst said that more significant intervention is the responsibility of regulators. Both members and guest underscored the role of the audit committee in ensuring that non-GAAP metrics are well defined, consistent, and reconciled to underlying statutory accounts. In the area of non-financial reporting standards, Mr. Hoogervorst foresaw a very limited role for the IASB.

For a list of discussion questions for audit committees, see Appendix 3, on page 11.

The IASB's structure and process

The IASB is a private, non-profit organization that develops accounting standards through an independent but open and participatory process that seeks input from all interested stakeholders. It has 14 members, who must have a "broad geographical spread"—current members represent the Americas, Asia/Oceania, Europe, and Africa—and "a balance of skills and experience drawn from auditors, preparers, users and academics."[2]

The IASB is governed and overseen by trustees of the IFRS Foundation, which is, in turn, overseen by the Monitoring Board, a governmental body consisting of representatives from the International Organization of Securities Commissions, the European Commission, the US Securities and Exchange Commission (SEC), and securities regulators from several other major jurisdictions, such as China, Japan, and Brazil. The Monitoring Board was created by the IFRS Foundation in 2009 to "enhance the public accountability" of the organization.[3]

While its oversight model is similar to that of national-level accounting standards setters like the Financial Accounting Standards Board (FASB) in the United States, the IASB develops standards for most countries in the world. Mr. Hoogervorst noted that IFRS has been widely adopted throughout Europe and Asia, most recently in emerging markets such as India and China. *"It is amazing that IFRS is now the most widely used economic standard around the world,"* he said.

A four-stage standards-setting process

The IFRS Foundation states, "The process for developing the Standards is highly transparent; every stage involves public consultation. The public can also access all Board papers and observe all Board meetings via our website or by attending the meetings."[4] The process includes four stages:[5]

- **Setting the agenda.** A technical work plan is developed every five years.
- **Research projects.** Accounting problems are assessed to determine if standards are needed.
- **Standards-setting projects.** Specific proposals are developed, consulted on, and finalized.
- **Maintenance.** New standards are reviewed and amendments proposed, if necessary.

Countries that use IFRS do not all accept new standards automatically. The EU requires listed companies to prepare their financial statements in accordance with IFRS, but there is a process for endorsing individual standards before they enter into force. After receiving advice from an independent expert group—the European Financial Reporting Advisory

Group (EFRAG)—the European Commission prepares a draft regulation. This draft is first approved by the Accounting Regulatory Committee, which consists of representatives from EU countries, and then submitted to the European Parliament and the Council of the EU for a three-month period of scrutiny. If there are no objections, the European Commission adopts the regulation.[6] In the past, the EU has on occasion adopted its own version of a standard, a so-called "carve-out."

At the meeting, Mr. Hoogervorst commented on the EU's approach: *"Europe doesn't blindly adopt our standards. EFRAG has technical staff that thoroughly go through each standard. There is the possibility of the EU not endorsing our standards—we don't have authority to impose the standards; public authorities decide. But that ensures that we are not in an ivory tower. It makes us listen as well as be firm."*

Convergence with US GAAP?

Two of the IASB standards completed in recent years, revenue recognition and leases, were converged standards. Such convergence projects represent an effort to bring IFRS and US GAAP closer together, with the aim of achieving a uniform set of global standards. The US SEC had considered eventually adopting IFRS as the US standard; however, after studying IFRS adoption for many years, it has taken no further steps in that direction.[7]

While the IASB and the FASB continue to work together closely, both Mr. Hoogervorst and his counterpart at the FASB, Russ Golden, have noted the challenges of achieving full convergence and a single set of standards. Mr. Golden explained to ACLN members in September 2016, "The laws in our country are different, the regulatory structure is different, and the culture may be different. We strive to have common outcomes, but we are not always successful in improving financial reporting and achieving common outcomes."[8]

At the meeting in London, Mr. Hoogervorst described recent, intensive efforts: *"Revenue recognition was fully convergent, and we converged on lease accounting; but on financial instruments (IFRS 9) we failed to converge, nor did we converge on insurance accounting. The only road to full convergence would be US adoption of IRFS. I don't see that happening in the near future."*

Assessing the impact of new standards

While one of the IASB's four major new standards is focused on insurance, the other three have broad, cross-sectorial impact. EACLN members' experiences with these standards prompted some of them to inquire more deeply into how standards are developed. A member asked what the IASB does to test costs and benefits: *"How does the IASB try to balance the resources that issuers need to comply with new standards against the system-wide benefits of the standards?"*

Mr. Hoogervorst said that the IASB is constantly consulting stakeholders on these kinds of concerns. *"Usually we know whether individual standards will be costly to implement,"* he said. However, he admitted that the other side of the equation can be hard to determine: *"It's impossible to quantify precisely the benefits of new standards, besides assuming the benefit to capital markets generally."* Mr. Hoogervorst also said that issuers are, if anything, more likely to provide input than investors:

> *We are open for comment letters; we track and answer nearly everything in the letters. The staff goes through all the letters, so the board is aware of the opinions out in the world. We have many meetings with parties—preparers and investors around the world. Those face-to-face meetings help us understand the emotion behind comments. Companies are most eager to talk to us; they are the ones with the knowledge of accounting and the application of the standard, as well as being highly motivated. Little escapes us in terms of preparers. Paradoxically, investors are not as engaged.*

Mr. Hoogervorst added, *"There is lots of politics involved, because choice still exists in accounting. The work doesn't just require technical ability but also diplomacy."*

The IASB also has a post-implementation review process, in which it tries to gauge how well a standard works once thousands of companies are actually trying to comply with it.[9] Mr. Hoogervorst suggested that the IASB might take a closer look at the costs and benefits of its new standards after they are fully implemented. *"It would be good for us to look at the standards after three years and measure their success and costs of implementation. We need quantitative data from business to show us the cost of implementing a standard like revenue recognition,"* he said.

The IASB's current focus on better communication in financial reporting

Mr. Hoogervorst indicated that after the recent period of significant change, the pace of standard setting will now slow. *"We have to back off and let companies digest what we've done,"* he said. *"We can't have constant change. We have filled the biggest gaps and need to give the system time to implement the new standards."* He also considered where the IASB might go next: *"Looking at the future agenda and having said we don't want to rock the boat too much, what else could we do? There are a few complaints about financial statements—that they are too voluminous and complex, and that there is high use of non-GAAP measures, undermining the use of the financial statements—so what could we do?"*

A central theme of the IASB's current agenda is "better communication in financial reporting." As Mr. Hoogervorst explained in a September 2017 speech, this agenda "aims to improve the communication effectiveness of the financial statements. We are continuing our work on disclosures, providing guidance on making materiality judgements and developing general principles for disclosure. This should help companies to remove clutter and make their disclosures more meaningful."[10] Other standards setters and regulators, such as the FASB, the SEC, and the European Securities and Markets Authority, are also looking at how to improve disclosure effectiveness.[11]

At the meeting in London, Mr. Hoogervorst elaborated on this agenda and its goals:

> *I do not think the relevance of financial statements is under threat. They are still relevant for investors, an important anchor of information. It is true that investors are looking more at other sources—for example, big data, non-GAAP measures, real-time information, the culture of the company, ESG [environmental, social, and governance] accounting—so financial statements are not under threat, but they need to be strengthened in order to help companies make disclosures more effective. I'm not going to paint a rosy picture that disclosures will be cut in half. But right now, they are a compliance exercise; they are just about avoiding regulatory or audit problems. That's not good because it creates huge financial statements.*

Reviewing the primary financial statements

A key element of the IASB's agenda is the primary financial statements project, which is a review of the structure and content of performance reporting, including the income and cash flow statements. In his September 2017 speech, Mr. Hoogervorst noted, "Investors want more disaggregation, additional line items and possibly subtotals that tell more about the performance of the company."[12] The IASB plans to issue a discussion paper or exposure draft on this topic in the first half of 2018.

At the meeting, Mr. Hoogervorst said,

> *Our work on primary financial statements is very important. IFRS is form free, but investors like subtotals and so do preparers. In IFRS, we define little between profit or loss—there is no defined EBITDA [earnings before interest, taxes, depreciation, and amortization]. Companies like to make adjustments for one-offs; we have no discipline around that. It's not our ambition to root out non-GAAP, but there is reason to be skeptical. We are examining a principled definition of EBIT, which will hopefully come close to what companies are currently using. It will be helpful for the investor community.*

Projects on materiality and principles of disclosure

The better-communication agenda includes several other projects seeking to improve disclosures, including projects on materiality, principles of disclosure, and elimination of redundancies, conflicts, and duplications. A final practice statement on materiality judgements was published in September 2017; it "gathers all the materiality requirements in IFRS Standards and adds practical guidance and examples companies may find helpful in deciding whether information is material."[13] The idea is to encourage companies to avoid using IFRS requirements as a checklist, helping them apply judgements that will be more useful for investors. Mr. Hoogervorst noted, *"We have adapted the standards slightly to show companies that if information isn't relevant, then it shouldn't be included in the reporting or in the notes."*

In the area of disclosure principles, the comment period for a discussion paper issued in March 2017 closed the following October. The IASB's goal for this project is, in part, to "identify disclosure issues and develop new, or clarify existing, disclosure principles in IFRS Standards to address those issues."[14] The discussion paper asked for feedback on, among other things, principles of effective communication, such as avoiding boilerplate language, being as simple and direct as possible, and highlighting important matters; the roles of different components of the financial statements and the notes; and the location of information, including when information needed to comply with IFRS can be provided outside the financial statements.[15]

Yet Mr. Hoogervorst underscored that, given the reality that financial statements are attempting to describe, there is ultimately a limit to how simple and easy to understand these statements can be. *"Financial statements are complex. The general public will never read them; they are for specialists who explain them to other audiences. They have become more complex over time because in the past there was false simplicity—it was not completely reflecting reality, as, for example, with pension statements. Business itself has become more complex, and it won't go back,"* he said.

The need to reflect reality is a rationale for more industry-specific standards. An EACLN member asked whether the IASB would consider industry-specific reporting standards similar to what is available in the United States. Mr. Hoogervorst said, *"We would still like for standards to remain industry agnostic,"* but he described recent exceptions in insurance and banking. He also mentioned that the IASB is working on a few other industry-specific standards, such as in the extractive industries, and added that the IASB could provide non-mandatory guidance on industry-specific income statement items. *"We know that non-GAAP measures are there to fill in that industry-specific information, and that's why not all non-GAAP reporting is bad,"* he said.

Non-GAAP metrics and other alternative performance measures

Mr. Hoogervorst and EACLN members elaborated on the value—and the pitfalls—of non-GAAP financial metrics (also referred to as non-IFRS) and alternative performance measures. These metrics are widely used by companies today to supplement their GAAP reporting. In a recent CFA Institute global member survey, 63.6% of respondents said they always or often use non-GAAP financial metrics, and several other surveys found similar widespread investor use of such measures.[16] This widespread use has attracted the interest of regulators in Europe as well as the United States, who are concerned that some of these measures may mislead, rather than help, investors. The IASB's discussion paper on disclosure principles (mentioned above) raises the issue of non-GAAP performance measures and considers some of the concerns they have raised and options for addressing them.[17]

Allowing but controlling the use of non-GAAP

Mr. Hoogervorst expressed support for the use of some non-GAAP measures: *"We do not wish to stamp it out. Our standards are not industry specific, and some industries need that. It gives additional insight."* EACLN members agreed that many of these measures are useful. One member explained, *"We use non-GAAP financial measures to be able to explain what is happening in the company, because you can't explain it with IFRS. In one of my companies, we presented our own report and the IFRS statements. We asked our stakeholders which they used; few used the formal accounting."*

However, members were concerned about the proliferation of non-GAAP measures, including some that obscure rather than clarify. One member was concerned about companies using non-GAAP to manipulate performance, especially when executives are remunerated based on non-GAAP metrics: *"You can argue both ways. You should highlight the KPIs [key performance indicators] used by management in the running of the company. They should be included if they are used to run the company; they should not be included if they are just KPIs used to make the company look good to investors."*

Mr. Hoogervorst and members discussed ways to improve the quality of non-GAAP measures. Mr. Hoogervorst said, *"We could provide more discipline or require evidence about when an adjustment is infrequent."* However, a member cautioned against too much intervention: *"I would hope that you wouldn't try to regulate non-GAAP. We need to use these measures to understand how management sees the company performing."* Mr. Hoogervorst noted that certain interventions, like limiting the number of metrics for indicating profits, are decisions that should be made by securities regulators, not the IASB.

The audit committee can also play a critical role in overseeing the use of non-GAAP. *"Alternative performance measures should be aligned to how the board wants to evaluate strategy and performance. I think the audit committee ensures that these metrics are clear, well defined, consistent, and reconciled to underlying statutory accounts,"* one member stated. Another added, *"We spend as much time reviewing non-GAAP measures as we do reviewing GAAP measures."*

Mr. Hoogervorst urged members to review non-GAAP measures carefully, especially those used in executive remuneration: *"As audit committee chairs, you have to be on top of these measures. The alternative performance measures used for executive remuneration tend to filter out everything adverse. This leads to situations where management compensation goes up, even during a downturn."*

A limited role for the IASB in non-financial reporting

Another kind of reporting that has received considerable attention in recent years is the reporting of non-financial metrics and information. This includes both quantitative measures, such as production metrics, and various kinds of qualitative information, which are elements of a more comprehensive kind of reporting known as "integrated reporting." It also includes ESG metrics such as greenhouse gas emissions and water usage. Organizations like the Sustainability Accounting Standards Board and the Climate Disclosures Standards Board have been developing standards to help investors understand how companies are performing in this broader sense, which affects not only society as a whole but also the long-term profitability of the company itself.[18]

In 2010, the IASB issued a non-mandatory practice statement on management commentary, which, as Mr. Hoogervorst explained in a recent speech, encourages companies "to report on the nature of the business, on its objectives and strategies, critical financial and non-financial resources, principal strategic, commercial, operational and financial risks, performance indicators and information about the company's prospects."[19]

At the meeting, Mr. Hoogervorst mentioned this guidance and elaborated on the IASB's current approach in this area:

> *We will never delve into sustainability reporting—it's not our expertise. However, it's clear that it is important for some industries regarding long-term value creation. Investors are increasingly looking at sustainability and you're probably writing about it in the management commentary. In 2010, we wrote guidance on management commentary—how annual reports should be written. There's increasing need for guidance, so yesterday we decided that our board would update it. It's not a mandatory document, but it would help crystalize all the work going on globally on items that are "non-financial" elements, which are in fact forms of financial reporting.*

Conclusion

Mr. Hoogervorst remarked on the IASB's status as a private body, including the advantages entailed: *"The IASB could have been an international treaty organization, but it would have been bureaucratic. We are small and agile, and we hire the best people."* He explained how the IASB develops its standards and assesses their impact, underscoring the inclusive and transparent nature of the process and adding that diplomacy as well as technical ability is required.

Turning to the IASB's current agenda, Mr. Hoogervorst highlighted the focus on clarifying communications, acknowledging that a certain level of complexity in the financial statements is unavoidable if those statements are to reflect reality. He endorsed the views of the audit chairs on non-GAAP measures, expressing support for these measures but urging the audit chairs to review their use carefully. He saw a limited role for the IASB in shaping both non-GAAP measures and non-financial reporting.

About this document

The European Audit Committee Leadership Network is a group of audit committee chairs drawn from leading European companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is organized and led by Tapestry Networks with the support of EY as part of its continuing commitment to board effectiveness and good governance.

ViewPoints *is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisors as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of* ViewPoints *lies in its power to help all constituencies develop their own informed points of view on these important issues. Those who receive* ViewPoints *are encouraged to share it with others in their own networks. The more board members, management, and advisors who become systematically engaged in this dialogue, the more value will be created for all.*

Appendix 1: Biography of Hans Hoogervorst

Hans Hoogervorst has been chair of the International Accounting Standards Board since 2011. He is currently serving his second term, which ends in 2021.

Mr. Hoogervorst is a former chairman of the executive board of the Netherlands Authority for the Financial Markets and a former chairman of the International Organization of Securities Commissions technical committee. He was appointed as a co-chair of the Financial Crisis Advisory Group, a high-level group of business leaders with experience in international markets, to advise the IASB and the FASB on their joint response to the financial crisis. He also served as chairman of the Monitoring Board of the IFRS Foundation, the oversight body of the IASB.

Between 1998 and 2007, Mr. Hoogervorst held a number of positions in the Dutch government, including minister of finance; minister of health, welfare and sport; and state secretary for social affairs. Prior to this, Mr. Hoogervorst served both as a member and senior policy advisor to the Dutch Parliament and the Ministry of Finance.

Appendix 2: Participants

Members participating in all or part of the meeting sit on the boards of over 50 public companies:

Mr. Aldo Cardoso, ENGIE

Ms. Carolyn Dittmeier, Generali

Mr. Ángel Durández, Repsol

Mr. Eric Elzvik, Ericsson

Mr. Byron Grote, Tesco, Akzo Nobel and Anglo American

Ms. Siân Herbert-Jones, Air Liquide

Mr. Lou Hughes, ABB

Mr. Arne Karlsson, Mærsk

Ms. Dagmar Kollmann, Deutsche Telekom

Mr. Richard Meddings, Deutsche Bank

Mr. Nasser Munjee, Tata Motors

Ms. Guylaine Saucier, Wendel

Mr. François Thomazeau, Bolloré

Ms. Martine Verluyten, STMicroelectronics and Thomas Cook

Mr. Lars Westerberg, Volvo

EY was represented in all or parts of the meeting by the following:

Mr. Jean-Yves Jégourel, EMEIA Assurance Leader

Mr. Hywel Ball, Managing Partner, Assurance, United Kingdom & Ireland

Appendix 3: Discussion questions for audit committees

- ? What are some key ways in which communication around financial reporting could be improved? What steps has your company taken?
- ? How can the IASB help improve communication and disclosures? What advice would you have for them as they move forward on the projects in this area?
- ? How should the IASB respond to the increasing use of non-GAAP measures? Should it tweak IFRS to reduce the need for non-GAAP, or just provide guidance on how to present these metrics?
- ? How does your board oversee the use of non-GAAP measures both in reporting and in managing the company?
- ? How can the IASB help companies with integrated reporting? What kind of guidance would you like from the organization?
- ? Is there a role for the IASB in ESG reporting? Even if they do not develop the standards themselves, can they help companies make sense of the standards already out there?
- ? How does your audit committee oversee non-financial reporting? Does it consider how non-financial metrics are calculated?
- ? How could the IASB improve its outreach to boards and audit committees?

Endnotes

[1] *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

[2] "Position Specification – Board Member," IFRS Foundation, accessed October 11, 2017.

[3] "IFRS Foundation Monitoring Board," IFRS Foundation, accessed October 11, 2017.

[4] IFRS Foundation, *Who We Are and What We Do* (London: IFRS Foundation, 2017).

[5] IFRS Foundation, *Who We Are and What We Do*.

[6] European Commission, "Financial Reporting: EU Rules on Financial Information Disclosed by Companies," accessed October 18, 2017.

[7] Tammy Whitehouse, "White Plugs for Accounting Convergence in Parting Statement," *Compliance Week*, January 9, 2017.

[8] North American Audit Committee Leadership Network, *Dialogue with Russell Golden of the Financial Accounting Standards Board*, ViewPoints (Waltham, MA: Tapestry Networks, 2016), 7.

[9] Gary Kabureck, "A Holistic Look at IFRS Standards: The Role of Post-implementation Reviews," IFRS, September 4, 2017.

[10] Hans Hoogervorst, "IASB Chairman's Speech: The Times, They Are A-Changin'" (speech, Accountancy Europe, Brussels, September 18, 2017).

[11] EY, *Applying IFRS: Enhancing Communication Effectiveness* (London: EYGM Limited, 2017), 2-6.

[12] Hoogervorst, "IASB Chairman's Speech."

[13] International Accounting Standards Board, "IASB Issues Practice Statement 2 Making Materiality Judgements and Publishes Exposure Draft Definition of Material," news release, September 14, 2017.

[14] International Accounting Standards Board, *Disclosure Initiative – Principles of Disclosure* (London: IFRS Foundation, March 2017), 4.

[15] International Accounting Standards Board, *Disclosure Initiative – Principles of Disclosure*, 5-6, 21.

[16] Vincent T. Papa and Sandra J. Peters, *Investor Uses, Expectations, and Concerns on Non-GAAP Financial Measures* (CFA Institute, 2016), 7.

[17] International Accounting Standards Board, *Disclosure Initiative – Principles of Disclosure*, 48-58.

[18] Hoogervorst, "IASB Chairman's Speech."

[19] Hoogervorst, "IASB Chairman's Speech."