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Developments in European Financial Reporting Regulation and Enforcement

Meet the Experts, London, 12 November 2012

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ESMA Chair

Ladies and Gentlemen,

It is a pleasure to be here today at Meet the Experts. I am delighted to see that the organizers have attracted such a large group of speakers and participants with experience of financial reporting and IFRS. Today I will touch upon four financial reporting topics namely: (i) consistent application and enforcement of IFRS in Europe; (ii) forbearance in the banking sector and the need for transparency; (iii) convergence with US GAAP; and, as I know there are many auditors in the audience today, I do not want to disappoint you and will say a few words on (iv) the audit proposals published by the European Commission last year.

But before I move on to the specific financial reporting topics, let me spend a few minutes on general ESMA issues to give you an impression of our activities in the past year, and which reflect our main objectives.

EU single rulebook

Since September 2011 we have developed 51 draft regulatory and implementing standards and six sets of guidelines in areas such as credit rating agencies, short selling, high frequency trading, and alternative investment funds. I specifically want to mention the 40 recently completed technical standards that were developed in order to meet the EU commitment to have rules in place for derivatives markets by January 2013.

In carrying out these tasks ESMA has ensured that all relevant stakeholders had the opportunity to provide input into our policy development process through open public consultations, and interaction with various stakeholder associations – representing both investors and market participants.

To ensure the effective implementation of the single rule book, and avoid regulatory arbitrage, ESMA has supported supervisory convergence by for example issuing opinions, including one on the treatment of sovereign debt under IFRS.

Financial stability and crisis management

ESMA's work on financial stability is a mix of regular risk reporting and specific projects. We have completed specific work on the risks associated with the current trend towards structured and complex retail products, the CDS market, and the shadow banking system in Europe.

I would also like to highlight key aspects of ESMA's coordination activities in the context of "adverse market developments". The Board of Supervisors of ESMA held several conference calls in early summer to discuss the significant worsening of financial market conditions in the EU. The objective of these calls was to exchange information on key financial market developments in the EU, planned responses to those developments by national competent authorities and to assess where, and what type of coordination, was needed.

Investor protection

ESMA has reinforced the European framework for investor protection through a series of concrete initiatives. In July 2012, ESMA published two sets of guidelines aimed at enhancing the protection of investors, and financial consumers more broadly. One set concerns the suitability of advice to financial consumers and the other set concerns investment firms' requirements regarding the compliance function.

Also in July, we published *Guidelines on ETFs and other UCITS issues* which are aimed at strengthening investor protection and harmonising regulatory practices across this important EU fund sector, through increasing the level and the quality of information provided by UCITS investment funds to their investors.

After the Summer we have published draft guidelines for consultation which address the alignment of remuneration with the overarching obligation on investment firms to act honestly, fairly and professionally in accordance with the best interests of its clients.

Finally, ESMA has also exercised its power to issue warnings. We have issued a warning on the main risks involved in forex trading, and a warning on using the internet for investment purposes, following an observed rise in complaints reported by national authorities.

CRA supervision

This is the first year in which ESMA has exercised its supervisory powers regarding CRAs and currently 18 CRAs have been registered and ESMA continues to receive further applications for registration.

In executing our supervisory responsibilities, ESMA's CRA Unit has undertaken two on-site inspections at the three largest registered entities. The first inspections were carried out in December 2011 and the findings were published last March, while a second round of on-site inspections has been completed after summer. The March report identified several shortcomings and areas for improvement for CRAs. On the basis of the second round of inspections on bank rating methodologies we are now examining the evidence in preparation of our supervisory findings.

Euribor

Let me also mention that as a result of the LIBOR and Euribor cases, ESMA conducts various activities on reference rate issues. Together with the European Banking Authority (EBA), we conduct activities concerning, firstly, the facilitation of the national investigations regarding Euribor. Secondly, a review is conducted of the Euribor system, covering the rate setting system and the submission process. Thirdly, guidance is developed for benchmark providers and market participants focussing on transparency, conflicts of interest and controls. This work complements and contributes to the forthcoming European Commission work in this area.

The ESMA organisation

In addition to focusing on its role in policy and supervision, ESMA has also devoted much of this year to developing its internal organisation so it can carry out its mandate while remaining sufficiently flexible to respond to any further responsibilities it may receive. We are growing from 45 staff in September 2011 to an expected 100 staff at the end of 2012, and I would like to stress that we are pleased with the calibre of our recruits.

Let me now move on to the specific financial reporting topics.

Consistent application of IFRS

Europe has been getting a lot of bad press lately. Some Member States have been criticised for endangering the euro, and the resulting debate is shedding new light on the economic governance of the euro area. The last months' discussions have rightly focused on enhancing prudential supervision and consistency throughout the euro area, more particularly in the banking sector. Establishing a banking union will surely contribute to the stability of the European financial system. However, financial stability is not only a duty for banking regulators, but for all financial services regulators, including securities regulators whose actions have contributed to maintaining a level of financial stability since the outset of the financial crisis. As I have described earlier, ESMA's activities are driven both by the investor protection objective <u>and</u> the stability objective.

We strongly believe that financial reporting with strong measurement principles along with entity-specific and relevant disclosures reflecting economic substance are important in underpinning market discipline. This contributes to investor protection and stability. Market discipline can only be achieved through the development and application of high quality accounting standards. This is where the International Accounting Standards Board (IASB) has an important role to play, by developing clear, auditable, enforceable and globally accepted standards

The worldwide adoption of IFRS is a necessary but, on its own, an insufficient condition for global comparability. In order to achieve true global comparability the standards have to be enforced. Research has shown that the mandatory adoption of IFRS by a jurisdiction results in reduced capital costs in the immediate mandatory adoption period – reflecting increased disclosure and enhanced information comparability – however, this is only really the case in countries with strong legal enforcement[1] frameworks.

In the European Union, the supervision of financial statements and their subsequent enforcement falls within the competence of national supervisory authorities. However, benefits of strong enforcement could disappear within the EU if we do not aim to improve on the consistent application at the Union level, and enhance comparability within the single market and at the global level. Therefore, consistent application of IFRS needs pan-EU coordination, which is one of ESMA's primary objectives. I have spoken about how ESMA does this in practice during past speeches and will not repeat myself here.

However, I would like to talk about common IFRS enforcement priorities in the EU, which we will publish today. This is the first time EU enforcers have agreed on common enforcement priorities highlighting the areas on which all EU enforcers will focus when reviewing 2012's financial statements. These areas are: (a) financial instruments; (b) impairment of non-financial assets; (c) defined benefit obligations; and (d) provisions that fall within the scope of IAS 37 – *Provisions, Contingent Liabilities and Contingent Assets*.

I would like to expand on each of these issues briefly:

- *Financial instruments*: since the beginning of the financial crisis, transparency related to financial instruments is a top priority. Issuers should provide disaggregated and expanded disclosures on material exposures to all financial instruments – not only sovereign debt exposures – that are exposed to risk. We would expect relevant quantitative and qualitative disclosures reflecting the nature of the risk exposure, elements related to the valuation of the instruments as well as an analysis of the concentration of exposure to relevant risks.

[1] Li, S. (2010) *Does mandatory adoption of International Financial Reporting Standards in the European Union reduce the cost of equity capital?* The Accounting Review, 85(2), 607-636.

- In addition, there should be due assessment at the end of the reporting period as to whether there is evidence that a financial asset is impaired. ESMA believes that issuers should be more transparent on how they assess the event or events triggering impairment.

- A last point on financial instruments: significant or prolonged: a significant or prolonged decline in fair value triggers the recognition of an impairment loss for equity instruments held in the available-for-sale portfolio. EU enforcers have observed diverging practices in the application of the relevant criteria and think investors would benefit from more transparency. So please tell them and us what is considered to be a significant or prolonged decline in value.

- *Impairment of non-financial assets*: the current economic situation increases the likelihood that the carrying amounts of assets might be higher than their recoverable amounts. The market value of many listed companies has fallen below their book value, a situation potentially indicating impairment and thus the need for an impairment test. ESMA considers that particular attention has to be paid to the valuation of goodwill and intangible assets with indefinite life spans, whenever significant amounts are recognised in the financial statements. ESMA emphasises the need to use assumptions that represent realistic future expectations and would expect issuers to provide entity specific information related to assumptions used, when preparing discounting cash flows (such as growth rates, discount rate and consistency of such rates with past experience) and sensitivity analyses.

- *Defined benefit obligations*: in some countries there is no, or no longer, a deep market in high quality corporate bonds whilst discounted post-employment benefit obligations should be determined with reference to such market. The crisis and economic downturn resulted in significant swings in market yields for some sovereign and corporate debt. The question could arise whether entities should change their approach when determining discount rates for their post-employment benefit obligations. ESMA would expect issuers to disclose the yields used and provide a description of how they determined them.

- *Provisions within the scope of IAS 37*: the measurement of provisions involves significant management judgment and could in the current market circumstances be subject to more uncertainty. The strong link between provisions and the risks an issuer is subject to, makes a case for high-quality disclosures. Nevertheless, European enforcers often find that only aggregated and boilerplate information is provided. Issuers should disclose for each class of provision the nature of the obligation, the expected timing of the outflows of economic benefits, uncertainties related to the amount and timing of those outflows as well as, if relevant, major assumptions regarding future events.

In summarising our enforcement priorities I have highlighted the need for improved disclosures. That is not because ESMA believes that disclosures could replace the recognition or measurement principles, but rather that it allows issuers to provide investors with high-quality information within a principles-based environment. We think that the IASB should set objective-based IFRSs (such as is currently the case with IFRS 7 – *Financial Instruments)* allowing a company's management to align it as best as possible to its own situation. However, a principles-based environment can only survive if clear and entity-specific disclosures, re-assessed at the end of each reporting period, bring useful decision-making information to investors. If not, detailed prescriptive requirements would need to be developed and we all know that what is important today will not necessarily be so in the next financial year. The only way to avoid this is to stop providing boilerplate information directly mimicking the standards.

Here I would like to specifically address the auditors in the audience, and ask them for their support in achieving this. We deliberately issued the European common enforcement priorities before the year-end so that companies and their auditors could – and should – take due consideration of them when preparing and auditing the IFRS financial statements for the year ending December 2012. Auditors have an important role to play in assuring investors about a company's financial position and performance, which is more important than ever for all companies, and especially financial institutions.

Forbearance

To introduce my next topic, I would like to highlight two developments affecting the European banking sector. First, while there have been some improvements in recent years, bank leverage is still high and a very important issue of concern. Thin equity buffers make banks vulnerable to shocks in performance and the economy. Second, many holders of bank loans are impacted by the difficult economic situation in the EU and are struggling to meet their obligations.

Today, there is a practice resulting from these two developments, on which I would like to go into more detail: the practice of forbearance. This concerns the situation where a borrower is in financial difficulties and does not pay on time, and the lender decides to wait and see, perhaps he even renegotiates the arrangement on more favourable terms. If a number of borrowers and banks have problems at the same time, the issue has not only a micro but also an important macro-prudential dimension. We are thus working, even more closely than usual, with the EBA and the European Systemic Risk Board in this area. The latter's Advisory Scientific Committee issued an interesting report on forbearance and bank resolution in July 2012[2].

[2] Advisory Scientific Committee of the European Systemic Risk Board (2012) Forbearance, resolution and deposit insurance. http://www.esrb.europa.eu/pub/pdf/asc/Reports_ASC_1207.pdf?52eabcc85854c94745014a75b32cc779

Under the practice of forbearance, the lender hopes to get his money back, waiting to see whether the borrower will eventually pay up which means taking a risk regarding the borrower's ability or willingness to pay. While forbearance can in some cases be justified and economically rational, it can also become a waste of additional resources if the banks continue to lend to their old debtors rather than to new clients. Continuing to lend to old debtors may be a way of "kicking the can down the road", so to speak, avoiding a credit event that would have to be entered into the books. Continuing to lend to old debtors may then become a case of throwing good money after bad. From the perspective of the overall economy, such a use, or misuse, of funds is an impediment to economic growth. Even if the old borrowers do not receive any new funds, banks with weak balance sheets may reduce new lending in order to make their balance sheets appear stronger, rather than by writing off old loans and recapitalising.

Personally, I think that Europe can learn a lot from the Japanese experience of the 1990s, which demonstrates some of the perils of forbearance. When the Japanese banking crisis began in 1992, it was known, or it should have been known, that many loans in the bank's books were worthless. However, fears of write-offs inducing open insolvencies motivated forbearance by banks towards borrowers and of supervisors towards banks. The avoidance of write-offs and the failure to acknowledge insolvencies had large economic and social costs. As banks continued to lend to problem borrowers, lending to new firms fell and growth slowed or stopped completely. Today there seems to be a consensus in the academic community that the strategy of "denial, deferral and opaqueness" was one of the main reasons why the Japanese crisis lasted for more than a decade, during which it stifled economic and social development.[3]

For this reason, I believe that it is important for lenders to clearly reflect in their financial statements the credit risk they are exposed to in relation to forbearance. They should do this by providing clear disclosures (including both qualitative and quantitative information) that help investors to understand the extent of the forbearance practices when the exposure is material and to evaluate the need for potential impairments.

US IFRS adoption

Let me now turn to an issue which is less technical but that has many technical implications and affects financial markets all over the globe and the competitiveness of Europe: the US SEC non-decision on IFRS. The publication of the SEC staff report last July represents an important milestone for the SEC in its evaluation of IFRS. Let me remind you that the SEC report was aimed to provide the SEC commissioners with the relevant information needed to decide whether, and if so, how, IFRS should be applied in the US. Today we understand that the SEC staff will provide a recommendation to the Commission on IFRS, but that no timetable for completing such work has been communicated.

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[3] T. Hoshi and A. Kashyap (2004) Japan's Financial Crisis and Economic Stagnation, *Journal of Economic Perspectives*, No 18, Winter, p 3-26.

Although fully understanding the domestic economic and political constraints of the US SEC, I am personally disappointed with the lack of ambition regarding IFRS on the other side of the Atlantic. Patience has been a real virtue for us over the last few years and there have been a number of efforts to facilitate the adoption of IFRS in the United States. To name just two: the IASB/FASB memorandum of understanding, and the monthly joint Board meetings.

Some of the efforts to facilitate US IFRS adoption were difficult topics for the IASB's constituents to accept, especially in Europe, but they were willing to pay the price to get the US on board. Today I cannot avoid the feeling that all these efforts do not seem to be enough which suggests that it will never be enough. I believe many people feel as I do, which is disappointment that there is no progress or clear sign of political will to keep IFRS adoption high on the agenda in the US. We have made so many far-reaching mutual decisions over the last years that it would be a shame to miss the opportunity by walking away from IFRS.

In any case, we should not accept that the lack of an American timetable for a decision and clear support for IFRS is further slowing down the IASB's technical agenda. We urgently need to finalise the post-crisis agenda with projects like impairment of financial assets and insurance contracts. On the fact that the IASB and FASB are not able to come up with joint proposals on the impairment of financial assets, I can only say that I truly believe that where there is a will, there is a way.

We cannot continue with the current US influence over the international standard-setter. Convergence can no longer drive the IASB's agenda and it is time that the Foundation and the IASB focus their resources on developing high quality accounting standards and the important challenge it faces to achieve consistent application.

This should not only be the case for the Foundation and the Board but for all actors – including the Monitoring Board (MB). In 2009 a Monitoring Board was set up to enhance the organisation's public accountability by establishing a link to a MB of public authorities. Three years later I think it is legitimate to assess the tangible results the Monitoring Board has achieved. True, public accountability is often about creating trust and cannot be easily measured. However, it is important to assess how the MB has ensured the public interest perspective in IFRS standard setting.

Audit

At the beginning of my speech I promised to say a few words on the proposals for audit published by the European Commission last year.

Like many other parties, auditors play an important role in fighting the current crisis. Some of you might not like to hear this, but we have to admit that there have been serious shortcomings in the performance of the auditing sector during the crisis and that we have to learn from that. Prior to joining ESMA, as you may know, I was active in the regulation and supervision of auditors. During my time as chair of the International Forum of Independent Audit Regulators (IFIAR), I was extensively involved in the exchange of experiences about national inspections regarding audits of issuers hit by the financial crisis. One result of this work that struck me was that many of the shortcomings identified do not relate to auditors being unable to handle complex issues, rather they relate to quite basic auditing issues. These include a failure to give sufficient attention to issues whether in terms of time, or a failure to escalate them to a sufficiently senior level within the audit firm.

As regulators we also saw that it took quite some time before the valuation of, and disclosure on, complex financial instruments traded in illiquid markets improved and met the right standards. I am personally convinced that if auditors had done a better job, investors would have had higher quality information on these financial instruments at an earlier stage and could have acted accordingly.

Today there are still areas where issuers and their auditors should improve further. We have published some of these as part of our common enforcement priorities, as outlined earlier. We expect auditors to challenge issuers appropriately on these (and other) issues.

Many improvements in audit can be initiated by auditors themselves. However, I think it is important to support this with improvements in the regulation and supervision of auditors.

Following the introduction of audit supervision in 2006, the European Commission now proposes to strengthen supervision, and to further improve the single market with harmonised standards, by for example requiring ESMA to issue guidance on issues like conducting audit quality assurance reviews. In the current European Commission proposals, ESMA is not going to supervise auditors directly; the competence for supervision remains with national oversight bodies who have a close understanding of the local market and its drivers. The knowledge and the good practices developed by some national regulators are an important cornerstone to build a stronger and harmonised European supervisory framework.

When preparing this speech I was thinking back to a speech I gave as IFIAR Chair at a conference organised by the European Commission about two years ago. My message then was simple: we need to be much more ambitious regarding international cooperation in audit oversight. At present there is a large gap between the level of cooperation and integration of auditing regulators compared with that of the international networks of audit firms that regulators need to oversee. A failure to increase the level of international cooperation is a substantial risk for the effectiveness of auditing oversight. I have not changed my opinion since then.

In the audit sector the group of largest networks is nearly identical in every country and continent, with day-to-day national auditing practices being strongly influenced by the regional and worldwide management of the international audit firms. Serious extra-territorial issues are inherent in the oversight of internationally active audit firms. Therefore, there is a need for a more consistent European approach to overseeing the sector. This particularly holds for the larger international audit firm networks, some of which have established legal entities covering their activities in more than one Member State.

The Commission proposals are now debated with the Council and the European Parliament. Whatever direction the European negotiations will take, we have to make sure that whichever system of oversight develops, it should be able to cope with audit firms’ practices: more international, more co-operative, more European.

Ladies and gentlemen, thank you very much for your attention.