IFRS

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IASB Chair's speech: The times, they are a-changin'

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In a speech delivered at Accountancy Europe's event in Brussels, Chair of the International Accounting Standards Board (Board) Hans Hoogervorst sets out his views on how financial reporting will continue to provide a vital anchor for investors in their evaluation of a company. At the same time, Hoogervorst notes that financial reporting and the work of the Board will need to ·olve, to ensure that IFRS Standards continue to meet the needs of market participants.

Introduction

I thank Accountancy Europe for this opportunity to deliver a speech on the future of corporate reporting. Your 'Core and More' report from 2015 was a thought-provoking and well-researched document on the future of broader reporting. Its content helped me shape my thoughts on the challenges the International Accounting Standards Board and the broader reporting community are facing. Today I would like to share these thoughts with you.

I would like to start with a concrete example that demonstrates that the financial statements of a company are not the source of all wisdom for investors.

Ever since going public in 2010, the car manufacturer Tesla has been losing money, burning through $7 billion of cash. Investors experienced a dilution of their shares, yet their market value reached a whopping $50 billion. Tesla overtook the market value of General Motors, even though GM sells more than 100 times as many cars as Tesla and does so profitably.

These remarkable data demonstrate that investors do not just look at the reported profit and the balance sheet to guide their investment decisions. Clearly, investors nurture very high hopes for the future of Tesla. They base their hopes on the company's intangibles: its technological prowess and its business model that combines the production of electrical cars and batteries. These intangibles are not captured in the balance sheet, so in the case of Tesla, the numbers in the financial statements probably play a limited role in the current market valuation of the company.

Tesla may be an extreme case, but it highlights a trend towards a widening gap between book values and market values of companies. Given the increasing role of technology and intangible platforms in the global economy, this may not be surprising. But what does this mean for the relevance of financial reporting?

There is more going on in the world of reporting. Companies are providing more and more non-financial information, mainly on Environmental, Social and Governance (ESG) issues and they are seeking a wider audience than investors alone. Another widely observed trend is the increasing availability of digital data and the emergence of Artificial Intelligence to mine these big heaps of data.

These developments create opportunities, but they also cause confusion and anxiety. With all this information being requested and provided, will we still be able to see the wood for the trees? Isn't the widely perceived problem of information and disclosure overload just becoming bigger and bigger? Isn't financial reporting in the classical sense becoming less and less relevant? What does the future hold for accounting standard setters and indeed for the accounting profession?

Keep calm and carry on

My first answer to all these questions is that we should keep calm and carry on. I am not at all concerned that the relevance of financial reporting is under threat.

First, for the very fact that financial reporting is primarily (but certainly not exclusively) backward looking, it offers the most concrete evidence of the performance of a company. For mature companies, the income statement is the 'hardest' and most comparable source of information for investors. It does not have just confirmatory value; it is also a vital starting point for any projections of future cash flows. That is the case now and I am sure it will still be the case in 10 years.

The financial statements will always remain an important reality check. During the Dot-Com Bubble at the beginning of the century, the increasingly absurd price-earnings ratios of Internet start-ups served to feed healthy scepticism that later turned out to be justified. These days, similar concerns are arising about the valuations of the Silicon Valley tech giants and short sellers are getting more aggressive by the day. Ultimately, all value creation has to pass through the financial statements. If it takes too long, the income statement will indicate that the intangibles of a company may have evaporated in thin air, possibly on the trajectory to planet Mars.

Second, the more information becomes available, the more need there is for comparability, standardisation and quality control. Accounting standards aim to achieve this, based on sound economic principles. Just think about the current diversity in accounting practices for insurance activities. No artificial intelligence in the world would be able to make heads or tails from information that is in many cases inherently flawed.

This is why I do not see the advent of Big Data and Artificial Intelligence as a challenge to the relevance of accounting standards. They can provide useful supplemental information—certainly in terms of speediness, but they will not replace the financial statements.

For all these reasons, I am confident that the financial statements will remain a vital anchor for investors in their evaluation of a company. Whilst this conclusion may provide some relief, we must beware of complacency. The times, they are a-changin' and we all need to adapt, the IASB included.

Better Communication in Financial Reporting

The first thing the IASB needs to do is to strengthen the relevance of financial reporting itself. As most of you know, the central theme of our current agenda is 'Better Communication in Financial Reporting'. The Better Communication 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.

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. Investors want more disaggregation, additional line items and possibly subtotals that tell more about the performance of a company. We will have to provide more and better structure to the income statement and the cash flow statement. The result should be better-formatted primary statements that provide better information without investors having to dig into endless pages of notes disclosures.

Better formatting of the primary statements should also facilitate digital reporting. This brings me to the third element of Better Communication, which looks at the changing nature of the consumption of financial information. Increasingly, investors are using electronic means to digest financial information, often produced by data aggregators. To enhance the quality of electronically provided data, it is imperative that the IFRS Foundation continues to develop its IFRS Taxonomy.

The IFRS Taxonomy is already used by a wide variety of market participants and regulators. It is on the verge of making a new quantum leap. The US Securities and Exchange Commission has recently mandated the IFRS Taxonomy for the filing of company reports by foreign private issuers. The European Securities and Markets Authority (ESMA) is looking to do the same in Europe; a proposition that seems to be broadly supported by influential ESMA stakeholders.

I think these developments can do much to improve the accessibility of digital financial information to investors. In addition, it can contribute to improving the quality of IFRS information in the data provided by, for example, the data aggregators. In turn, once regulatory filings become digitised, this will open up a wealth of information about how IFRS Standards are used in practice. The feedback from regulatory filings might inform us, for example, on the formatting decisions we need to take in our project to improve the Primary Financial Statements.

A fourth step that the IASB may need to take is to give preparers more guidance on how to provide context to their financial statements. This should enable companies to better explain their strategy for long-term value creation.

The IASB has always been aware that financial reporting in the narrow sense has its limitations. In our Conceptual Framework we acknowledge that general purpose financial reports are not designed to show the value of a company and that users also need other sources of information to make their estimations.

Integrated reporting

Our awareness of the limitations of financial reporting in the narrow sense is one of the reasons that the IASB issued its non-mandatory Management Commentary Practice Statement (MCPS) in 2010.

This Practice Statement encourages management to provide context to the financial statements. It encourages management 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.

Essentially, our MCPS was an early foray of the IASB into integrated reporting, because all the elements of information it mentions are important components of integrated reporting. The management commentary enables a company to explain its strategy for long-term value creation, which is the essence of the International Integrated Reporting Framework.

The Management Commentary is also a good platform for companies to describe and explain the intangibles that are vital to their business model. The capital markets need information on how intangible resources are being managed in the context of a company's strategy.

However, measurement and outcome uncertainty of intangibles are, and will remain, formidable obstacles for any efforts to quantify them reliably. Even when intangibles have undeniable value, their existence can be ephemeral. Just think about the fate of some mobile phone companies in the recent past. Their seemingly unassailable technologies were destroyed almost overnight... For these reasons, the narrative of corporate reports—rather than the financial statements—will most likely remain the best place to deal with intangibles.

Since the publication of our Management Commentary in 2010, the world has moved on. There is an increasing interest in integrated reporting with its focus on long term value creation and a greater emphasis on connectivity, for example on how external developments affect a company's strategy. Several important documents have been produced that have further developed thinking on integrated reporting. I would like to mention the Strategic Report Guidance by the Financial Reporting Council in the UK and, of course, the <IR> Framework.

It is also clear that there is an increasing awareness that environmental and societal restrictions have an impact on long-term value creation. The establishment by the Financial Stability Board of the Task Force on Climate-related Financial Disclosures is a notable example of this trend. Our Management Commentary Practice Statement is silent on these issues.

These are all reasons why the IASB is currently looking at the question of whether we should take on a project to update the MCPS to reflect these new developments. I think there are reasons to do so. We are especially well-placed to make sure there is a good fit and connectivity between the financial reports and the non-financial information. I believe this connectivity to be essential to the success of integrated reporting.

Environmental, Social and Governance (ESG) reporting

I now come to the last part of my speech, which will be devoted to Environmental, Social and Governance (ESG) reporting. In the remainder of my speech, I will also refer to ESG as sustainability reporting, as this seems to be common practice in the market, although I ɔpreciate that there are varying definitions of both ESG and sustainability reporting.

The 'Core and More' report sketches how sustainability reporting has grown exponentially in recent years. Indeed, most of the volume-expansion of annual reports is due to extended ESG reporting. About one third of sustainability reporting instruments are voluntary, while roughly two thirds are mandated by (mostly national) public authorities.

The audience for sustainability reporting is broader than that of financial reporting; it can even encompass society at large. ESG standards encompass a big variety of areas: from human rights and working conditions, to highly technical matters such as the emission of greenhouse gasses and pollutants.

Different from financial and integrated reporting, much of sustainability reporting is primarily focused on the *external* effects of the performance of a company. It aims to report on the value eated (or destroyed) by a company to collective goods like the environment or social well-being. ESG reporting requirements often aim to entice corporations to act responsibly and to take broader public goods into account. ESG reporting can even be directly linked to public policy: for an emission rights trading scheme, for example, reliable carbon reporting can be essential.

The 'Core and More' report rightly notes that the world of sustainability reporting does not provide the same kind of global comparability that exists in the world of financial reporting. The report calls for 'decisive leadership' to establish an international standard-setter and even poses the question if the IASB as renowned international standard-setter should provide at least part of that leadership.

So what is it that the IASB could do?

The IASB and wider corporate reporting

Let me first note that, despite the differences in focus and remit, the world of financial and ESG reporting are not completely separate. A number of organisations, notably the Sustainability Accounting Standards Board and the Climate Disclosure Standards Board, develop their standards specifically to address investors' needs. Due to growing investor sensitivity around social responsibility and environmental sustainability, these issues have a growing impact on the future profitability and valuation of a company. To the extent that this is the case, management commentary or an integrated report should take these factors into account. This is something the IASB could take on board in updating our MCPS.

Secondly, the IASB is a member of the Corporate Reporting Dialogue (CRD), currently chaired by my former colleague Ian Mackintosh, which seeks to improve cooperation and harmonisation between its members. A concrete and very promising initiative of the CRD is a project to align the climate-related metrics of its member organisations: CDP, the Sustainability Accounting Standards Board (SASB), the Global Reporting Initiative (GRI) and the Climate Disclosure Standards Board (CDSB).

Nevertheless, I do not think the IASB is equipped to enter the field of sustainability reporting directly. Our focus on financial reporting for capital market participants is deeply embedded in our DNA; widening the audience and scope of our work would most likely lead to loss of focus and identity. Moreover, our main area of competence is economics. ESG reporting to wider stakeholder groups requires expertise that we simply do not have.

If we want to create more clarity in the somewhat chaotic world of wider corporate reporting, we all need to define clearly what our responsibilities and competences are. If we all try to do everything, the most likely outcome is that nothing gets done properly.

If not primarily the IASB, who then should take responsibility for harmonisation of ESG requirements and try to prevent overload?

Since so much of ESG reporting is closely intertwined with public policy goals, I believe that public authorities would be best equipped to pursue harmonisation. It took bold action by the European Union to make IFRS into an international standard; given the even bigger political sensitivity of sustainability reporting, determined political action in this field is even more important.

Yet I have to admit immediately that achieving this will be very challenging. ESG reporting is more diverse than financial reporting and has a much more varied group of stakeholders, even among public authorities. Its understandable political sensitivity is not going to make things easier. In sum, the road to international harmonisation is likely to be long, winding and rocky.

As a start, it would be wise for public authorities not to keep on adding to the diversity and (possible overload of) ESG reporting requirements. Stacking requirement upon requirement leads to a rapidly declining marginal effect. It would also be wise not to foster unrealistic expectations of ESG reporting. ESG reporting is good, but direct public policy action is often better and more effective.

Let me give you an example: in their sustainability reports, soft drinks producers are very keen to show how they try to entice their customers to reduce their sugar intake and pursue a more active lifestyle. Yet this does not stop the same industry from lobbying actively against the imposition of a sugar tax, which would likely be much more effective. Sometimes, ESG reporting is heavier on PR than on substance.

Another example that comes to mind is that of a grocery chain that is genuinely committed to sustainability reporting. Despite this commitment, its plastic shopping bags have burdened the environment for many years. All it took was a simple political decision forcing supermarkets to charge 5 cents for the plastic bags to reduce their use by 85%. So simple, so effective.

Finally, the Great Barrier Reef is already half dead and will be completely dead in 15 years. It is good that the G20 asked the FSB to do something about climate disclosures. But surely we need more drastic action from our politicians to prevent the catastrophic consequences of climate change...

To address the big environmental questions of our time it is urgent that the damaging external effects of economic activities are fully translated into their price through taxation. Proper pricing will reduce such activities and encourage development of cleaner alternatives.

Proper pricing of externalities would also mean that regular financial reporting would become more reflective of sustainable business activities. A kerosene tax would cause the financial reports of the aviation industry to reflect the true costs of flying. A realistic carbon tax would cause the financial results of smokestack industries to reflect the true costs of their products. Stranded assets would immediately be subject to impairment under IFRS standards. Financial reporting would become sustainability reporting...

Close

That ideal world is still far away, I am afraid. In the meantime we will have to make the best of the imperfect world of corporate reporting. The IASB is ready to adapt to the changing world of corporate reporting by increasing the communication effectiveness of the financial statements, facilitating electronic consumption of financial data and by promoting integrated reporting. I hope my contribution of today has made clear what the IASB can and cannot do to create a bit more clarity in this imperfect world.