

THE TECHNICAL, POLITICAL AND SELLING ASPECTS OF STANDARD SETTING

By: Jonathan Dingli

Interview with Philippe Danjou, Member of the International Accounting Standards Board (IASB)

The Malta Institute of Accountants recently had the privilege of welcoming Mr Philippe Danjou, Member of the International Accounting Standards Board (IASB) – the body which promulgates International Financial Reporting Standards (IFRS) – at the Institute’s premises. Mr Danjou accepted the Institute’s invitation to participate in an outreach event, which was held on 20 October 2011, at which Mr Danjou addressed the Institute’s Members and gave them an update on recently completed projects and others on the agenda.

Jonathan Dingli met Mr Danjou during his short stay in Malta to learn more about his experience on the Board since his appointment in 2006, to what extent has the IASB’s work been influenced by the convergence project and the financial crisis, and which IASB projects currently in the pipeline may be coming to fruition in the short to medium term.

the Accountant: You have been appointed to the IASB in July 2006 and your term will expire in June 2016. During this period the Board was, is, and is expected to be extremely busy developing standards resulting from the MoU and issuing standards in response to the financial crisis, not to mention ongoing work on other standard setting activities and the eventual adoption of IFRS in the US. Talk us through your experience as member of the Board so far.

I’ve been on the Board for over five years and probably as an initial reaction to your question I would say that the amount of work we had to do and are still doing is probably a little bit in excess of what I expected when I joined. Although I was not expecting a pleasure cruise, the pace of activities has increased significantly over time. When I started in 2006 the Board was quite busy working on the MoU (Memorandum of Understanding) project which involved very time consuming items, such as business combinations, which incidentally was the

first big one on which I had to form a view and vote.

With the rolling out of the crisis in 2007 & 2008, things took a very different twist – a total change in the type of work and the rationale. I think that’s probably the time at which the work of the IASB came under the scrutiny of politicians and the world at large who were asking questions about the accounting aspects of the crisis on topics such as fair value. That placed huge demands on the IASB which had to come up with energetic and timely reactions to address these concerns.

For instance the Board had to address with urgency the application of fair value when there are no liquid markets, which was the case during the crisis. We had to do a lot of quick fixes to standards, and that was done under pressure. There I realised that accounting standard setting can be a political exercise, in a way, as the Board came to be accountable to people who would never normally be interested in accounting. So when I saw accounting issues being given top priority by people as important as President Obama or President Sarkozy, to the extent of discussing accounting at the G 20 summit, then it opened up my eyes to the fact that there is another dimension vis-à-vis financial stability and the public perception of what we do, which was relatively new to me.

Until 2006/7 accounting standard setting was mainly a technical exercise, done by a group of experts *in camera*, who knew what is best for the markets and we published standards, with some outreach after discussion papers and exposure drafts had been published, but not that much efforts to really engage with people who were likely to be affected. And what became clear around the time of the crisis is that people are not ready to accept standards without a good degree of participation in the standard setting process after appropriate exposure of the proposals to the rest of the world. So with this change in focus, the Board not only had to re-think and



re-write the technical aspects of the standards in urgency – revisiting accounting for financial instruments, off balance sheet financing, consolidation, special purpose entities, fair value accounting when there are no liquid markets, etc – but we also realised that we had to change the approach to standard setting and that we needed to really improve the due process, and increase outreach and consultation.

So, in summary I witnessed an evolution of the processes followed by the Board, as a result of which the Board ‘opened up’ to the World; still a good deal of technical work going on, but certainly much more in terms of convincing people to “buy” the standards.

When dealing with recommendations coming from the politicians, we had to learn that not all that they want is always good and that we had to be careful in responding to political demands and not bend to short term solutions which are not good in the long term. For instance, while I can understand the sensitivity to the situation of banks (and banks are very important) – one has to acknowledge that it is not accounting which is responsible for keeping banks ‘alive’. And the world’s economy cannot depend on accounting solutions for keeping banks afloat. We can help reduce the pressure – if a bank has difficulty in using the latest (distressed) market price which leads to a bank reporting significant losses with potential negative consequences such as having a run on the bank

– that certainly is a matter where we had to be considerate. Accounting should not create excessive impacts and valuing something to an inflated market price can be dangerous if it is not a fair reflection of fair value. So it is justified to fix those problems, though accounting cannot and should not be used to shadow or hide real problems, and if a bank has to record losses then let it record them and you cannot create accounting rules that would defer losses to future periods because that would certainly backfire at some point. Whether such valuation losses should have an effect on regulatory capital is a matter to be dealt with by banking regulators.

the Accountant: Preparers, users and auditors alike often criticise the IASB for allowing too much influence from the US in the development of IFRS. One standard which could perhaps strengthen their arguments is IFRS 3 which was issued in January 2008 after 11 votes in favour and 3 against at IASB level. To what extent would you agree with such criticisms?

To a very limited extent I would say. It is true that, historically, when you look at the composition of the IASB when it was set up in 2001, it was very much under Anglo-Saxon influence with the key members of the Board being drawn from the US, the UK and Commonwealth countries – people who’s accounting philosophy was pretty much Anglo-Saxon. The so-called G4+1 group of people, who were drawn from Anglo-Saxon standard setters, certainly had a lot of influence initially.

That has changed over time – the composition of the Board has evolved quite a lot and today the Americans are in a minority. The rest of the World has come on board and now we have a much more balanced composition of the IASB. This being said, one must acknowledge that the US have a very good set of standards – the US GAAP – which have been developed over time as a result of very good due process and a lot of work. With US GAAP being what it is, a high quality set of standards, it is only normal that those standards have some influence on our technical work; it is normal that you draw thoughts from those ideas. Until recently, there was little technical work being done in Europe and elsewhere to bring up new ideas to the Board to counter balance that influence.

Now I’m very happy to see that, at least in Europe, a lot of work is being done to develop and structure the continent’s contribution to accounting and its influence on the work of the IASB. And I have to commend here the work of EFRAG as the coordinator of these efforts in Europe. We also witness the emergence of cooperation initiatives in other regions of the world (e.g. AOSSG in Asia – Oceania, GLASS in Latin America).

So yes there has been in the beginning a lot of influence from the US and the Anglo Saxon world – but this has gradually been replaced by a lot of influence coming from other jurisdictions. The membership of the Board is now also more balanced and there are more people with different views coming from different jurisdictions.

You mentioned IFRS 3 as an example. Well if you look at the changes that were made on each side – whether it is from IAS 22 to IFRS 3 or from the old to the new standard

under US GAAP, the US made more changes to their business combinations standard than we have. The new standard, which is a joint standard, has been more influenced by the views of the IASB than the FASB's, at least in terms of changes made to previous standards on each side of the Atlantic.

The fact that three members of the IASB voted against IFRS 3 is just a sign of democracy – you cannot always achieve unanimity. Three votes against is not unusual in standard setting. Going back to IFRS 3, I would for instance point to the issue of the “full goodwill”. As you know IFRS 3 retained both the full goodwill and proportionate goodwill methods. The fact that we did not accept the US solution (only full goodwill), and that we made it only an option, is just a proof that we did not bend to the US view.

Similarly, if I may refer to the current debate on impairment, we do not buy and we are not convinced by the US idea to calculate a day 1 loss on the impairment of originated loans. We also disagreed on and rejected the full fair value model for the classification and measurement of financial instruments. In 2008 we exposed a discussion paper exploring the possibility of going to full fair value to simplify accounting for financial instruments, but very soon after we decided not to go for it and instead keep a mixed measurement model while FASB was heading towards a full fair value.

There are many other cases which show that we do not necessarily always accept US views.

the Accountant: The US seem to be taking long to make up their minds on whether IFRS will be allowed or adopted in the US or otherwise. EU Commissioner Barnier on the other hand is on record saying that their patience has a limit. The IASB is presumably caught somewhere in between. Do you see and end to this saga?

It is true that we are caught in between – not necessarily between the US SEC and the European Commission – we are caught in between two conflicting demands. On one hand the leaders of the G 20 keep on affirming that there must be one unified single set of standards worldwide for financial reporting and they asked the FASB and IASB to converge and to come to a single unified language.

On the other hand we have people or jurisdictions who tell us “enough is enough”, and “do not extend fair value accounting”. So to a certain extent the conflict is between the message we get from the G 20, which is supposedly the highest political level on this planet, and stakeholders' views. We think that we should keep on doing reasonable efforts to bring the US on board. Of course there must be a limit to this exercise: for us it is not a matter of patience. It is just a matter that we are investing a lot of time and efforts and we need to see a return on this investment.

One should not underestimate the importance of the transition project for the US. It is not easy to push a change in such a big continent – from one set of standards which are well known to something which is a relatively new undiscovered territory. Of course there are people in the US who have very

good knowledge of IFRS as they have been monitoring the developments. And those are the ones who are generally positive about moving to IFRS. The vast majority of the constituents in the US still do not really know what IFRS is. They fear the unknown. They know it will cost money and efforts, but they don't know for what benefits.

The more internationalised a company is, the more pro-IFRS it is because it has already experienced IFRS: it has subsidiaries reporting under IFRS, it has foreign investors who know about IFRS... But purely local listed companies with no foreign investments, no foreign investors and no subsidiaries out of the US, still have to learn about IFRS. Probably they don't see any immediate benefits in the change to IFRS.

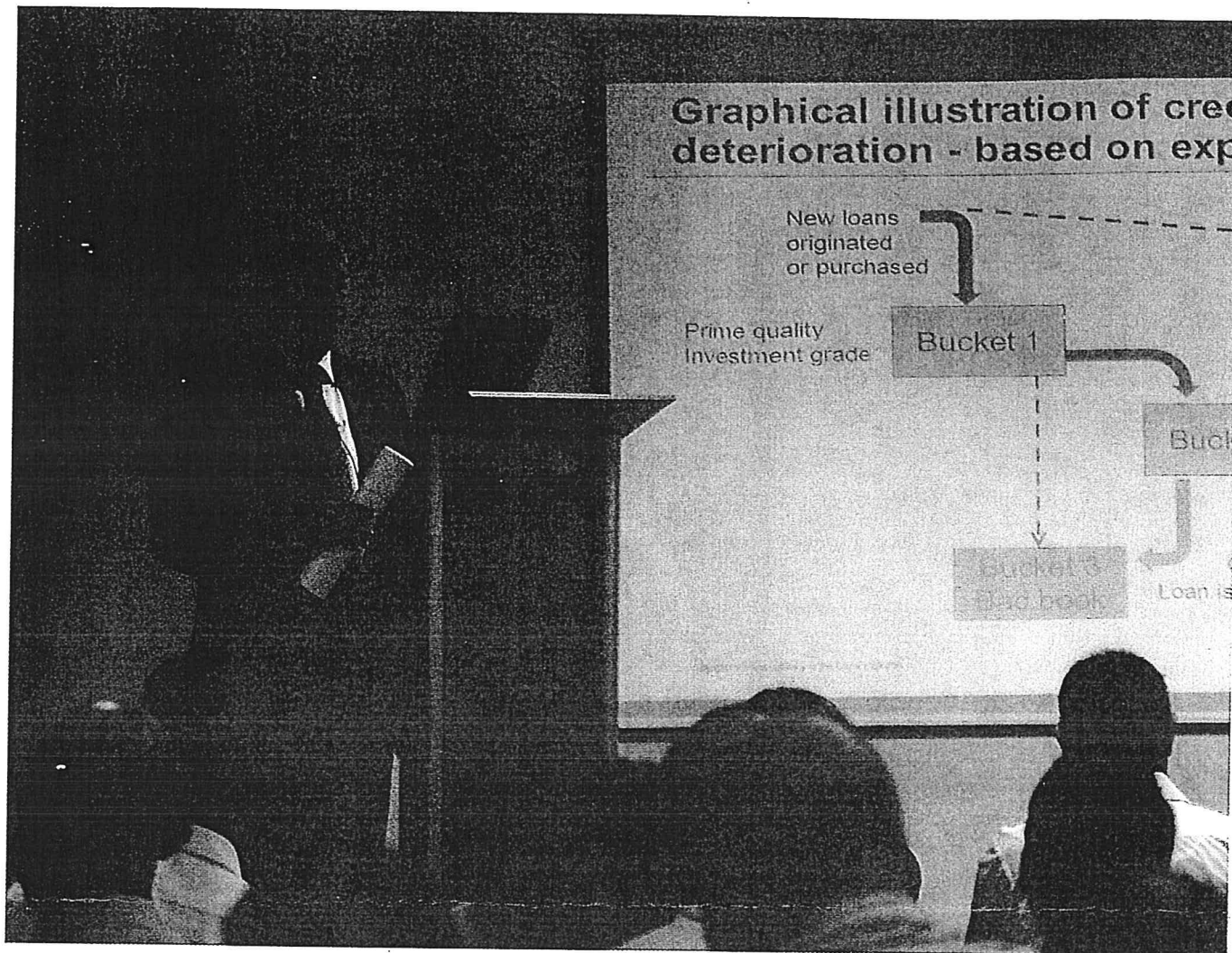
So that is one of the reasons why the US is slow in taking a final decision. One has to acknowledge that in accepting IFRS in 2007 for foreign private issuers (listed on a US stock exchange) the US made a very bold step as it recognises that a US investor buying shares of a foreign company listed on a US stock market is well protected by IFRS. It is certainly a very positive starting point. Now the question is whether to make IFRS mandatory for all US companies or to make it an option for certain companies and hence adopt a dual reporting system – there are merits to each of the two approaches.

In contemplating going for the first option and make IFRS mandatory for all listed companies, there are a number of factors which cannot be overlooked. First, the SEC must be convinced that the conditions will be there not to make it too chaotic for the markets. I think some people tend to underestimate this because in Europe we have had a relatively easy transition. But the EU had no point of departure – it had no common set of standards. So it was not a change of standards – it was just moving from a very fragmented situation to a unified language. The advantages were absolutely evident. The major disadvantage of giving up a good set of standards was not there. The US would change from a good set of standards to another set of standards. So it has to be proven that our set of standards (IFRS) is at least as good as the existing one, and that the cost of changing over is justified by the incremental value of our standards. So it takes a long assessment to address all these concerns and it would not be realistic to expect that the US will decide before they are convinced.

We are optimistic that we can make the case and that in the end we will have a positive decision, but to set a deadline or to say that it's either now or never could be counterproductive. Let's be a little bit more patient, let's understand the problem, let's try to convince and yes at some point we will have to make a decision and that could mean the end of the saga. But we can hope it will not happen this way.

the Accountant: It is quite unusual (if ever) for the IASB to issue a second version of an exposure draft. Yet it has done so twice this year on two separate projects – revenue recognition and leases. Do you have any comments to make on this?

In the past we did re-expose, maybe not a full exposure draft but limited exposures, on a number of cases. If we pick up those two that you mentioned, revenue recognition and lease



contracts, they are so important. And they are so much changing current practice to a new practice, at least for certain companies, that we cannot run the risk of getting it wrong.

In the Revenue recognition project we are dealing with the first line in the P&L, the most important maybe, the one everyone looks at. And changing the criteria for revenue recognition is an extremely high risk project as the cost of implementing the standard can be significant depending to what extent a company is affected by those changes. So the standard has to be absolutely water tight, checked, double-checked, and tested before it becomes a final standard.

The re-exposed revenue recognition document contains lot of changes. We listened to what people told us and changed the proposals accordingly in response to their concerns while of course making sure that the standard remains operational and that it will not have any unintended consequences. So we need more time – we are not in a rush to change the standards as today revenue recognition is not fundamentally broken. So we can afford taking some more time to ensure that we come up with the right solution.

Leasing also has a potentially significant impact on companies that will have to recognise assets and liabilities that are currently off balance sheet. Again we want to make sure that all the solutions we are adopting to simplify on the

initial proposals will result in a good standard. Arguably we are not actually re-exposing the accounting for the lessees but exposing for the first time a complete set of principles for the lessor model. While we had developed much more the lessee model in the initial phase of this project, we had devoted less time and resources to lessor model. Now that we have done more work and finalised the lessor model we need to expose it. However, because there is a lot of interaction between lessor accounting and lessee accounting, exposing lessor accounting implies re-exposing lessee accounting so that constituents can see a complete picture of lessor and lessee accounting in total and they can comment on the full 'package'.

So that's the reason why we exposed or re-exposed the standard on lease contracts. And I think people are quite happy that we do so – it is what they asked for – and they wanted to have the full picture.

the Accountant: The IASB has recently been seeking guidance on which areas it should focus in the next few years. In your view, what areas of major importance is the IASB likely to focus on in the next two to three years?

If we were doing this interview in a few months' time I would be better placed to answer your question. So for this interview I will have to do some kind of forecasting

of what I expect people to tell us in this consultation. I'm pretty much expecting that respondents will call for a period of calm, starting from 2015, so preparers and users can 'digest' the new platform. There are a number of good standards coming into force: revenue recognition, leasing, financial instruments, etc. But they will require significant modifications in accounting systems and in financial communication.

At the same time probably the same people will tell us that stability does not mean "no change at all" – it probably means no big change – as the Board will still need to address and fix a number of problems that we have today. We must complete the house. The house is nearly finished but there are still a few missing answers. So for instance I will not be surprised if people ask us to add something on extractive industries, which attracted a lot of interest at least from the industry. People want to see an IFRS standard which, perhaps, does not change but confirms current practice which is very much influenced by US GAAP.

I expect that some respondents will ask us to address "green accounting", for instance emission rights. This has become an important economic element – the markets on emission rights and the systems are developing – so we need to do something to address this specific issue.

Others will probably ask us to address business combinations under common control which, as you know, is currently out

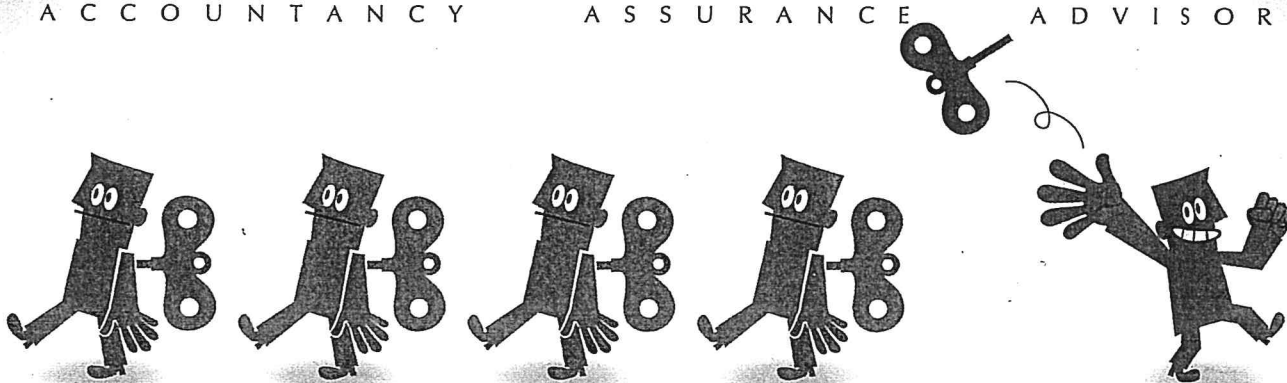
of the scope of IFRS 3. There are very different ways to deal with such transactions, there is no comparability so we must complete the house and build that part of the business combinations accounting to complete the project.

I expect that a good number of respondents will ask us to clarify what goes to OCI (Other Comprehensive Income) and what goes to Profit or Loss and whether and when OCI should be recycled to profit or loss. We have in the past made random decisions, or let's say we made decisions that do not seem to be aligned or based on concepts, as to what goes to OCI and whether it is recycled or not. The current provisions lack a conceptual basis! So I'm absolutely convinced that many people will push for a project on dealing with OCI and P&L.

Last but not least, there will probably be an overwhelming demand for us to complete the Conceptual Framework. We have been progressing at a very slow pace in the last five years. We've completed the first phase and started some work on the second phase but we need to do more work to complete the Conceptual Framework.

So in my view these are the areas which respondents are likely to want us to address. Of course there might be unexpected suggestions coming from the consultation – matters that we have not yet considered – and which might be deemed as important by the respondents to the consultation. So we are looking forward to that.

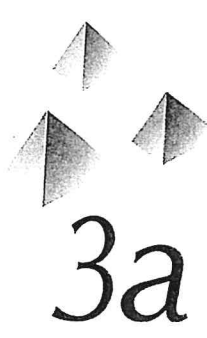
A C C O U N T A N C Y A S S U R A N C E A D V I S O R Y



We value your drive
& ambition

For us You're not
'just a number'!

If you are looking for a rewarding career, 3a can offer you a positive and challenging work environment for growth and specialisation, within a multi-disciplinary team where we can mentor you to maximise your professional potential serving a growing list of local and international clients. Get in touch should you wish to join 3a and bolster your career prospects...



3a Accountants The Penthouse Level 3 Palazzo Ca' Brugnera Valley Road Birkirkara
Tel +356 2757 2757 E-mail info@3a.com.mt Web: www.3a.com.mt