IFRS: Mission accomplished?

Ten years after the financial crisis, how have IFRS changed the role of the CFO within organizations?

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Since the inception of IFRS—the somewhat idealistic project of creating an internationally recognized accounting framework—IFRS have changed the paradigm for financial analysis and the use of financial information. The collective impact of individual new standards (IFRS 9, IFRS 15, IFRS 16) is an accounting evolution prompted by the fallout from the 2007 financial crisis. However, in conjunction with the need for a combined financial and risk dataset, IFRS have also sparked a revolution for the CFO function that goes far beyond accounting alone.

Back in 2008, less than a year after US subprime mortgages triggered widespread disruption to the global financial system, the balance sheets of financial institutions were burdened by assets that suffered rapid and major declines in value.

In reaction, financial institutions and/or governments often created "bad banks" to isolate such toxic assets, reduce leverage, and respond to increased demand for liquidity, thus hindering access to credit and draining liquidity out of the market.

To re-establish confidence in the soundness of capital markets and financial institutions, both international and national authorities took emergency steps to facilitate an adjustment to credit access and dampen the impact on the real economy.

These measures included monetary and fiscal stimuli, central bank liquidity operations, policies to promote asset market liquidity, and regulatory action to resolve specific situations. As part of these measures, financial institutions had to take steps to rebuild capital and liquidity cushions, forcing their clients, whether large corporates or SMEs, to adapt their working capital and debt management processes to this new environment.

The common objective of these reforms was to avoid a recurrence of the financial crisis. In order to be comprehensive, the recommendations included a set of changes to accounting practices—at least in terms of those that were most widely used—US GAAP and IFRS. Aside from the convergence of these two accounting frameworks, the most significant changes were aimed at decreasing the pro-cyclicality of the accounting frameworks used at the time of the financial crisis.

In 2018, 10 years since the reform began, the time has come to assess the current and future effects of the new IFRS in terms of restoring the robustness of financial institutions' balance sheets.

Aside from this primary objective, these new standards have also had significant ripple effects within organizations and more specifically on the role of the CFO. And given the fact that we are at an early stage in the implementation of these changes, we could expect the consequences to continue in the future.

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The purpose of IFRS and effects on the Economy

With the public interest in mind, IFRS were originally designed to develop "high-quality, transparent and comparable information in financial statements to help investors, participants in the world's capital markets and other users of financial information make economic decisions"[1].

The objective of adopting IFRS[2] for use in the European Union was to improve the efficiency of EU capital markets.

In 2014, the European Commission decided to assess whether it had achieved its goals as part of the Regulatory Fitness and Performance Program (REFIT).

As we can see from the figure below, the conclusions of this assessment were fairly positive. IFRS provide benefits for: (i) EU integration, by reducing cross-border barriers via a common international accounting language, and (ii) the strength of the EU, by creating a consolidated voice. While there is still work to be done on the transparency and comparability objective (one of the three items identified as potential areas for improvement), IFRS have increased transparency and led to greater comparability between financial statements within and across industries or jurisdictions.

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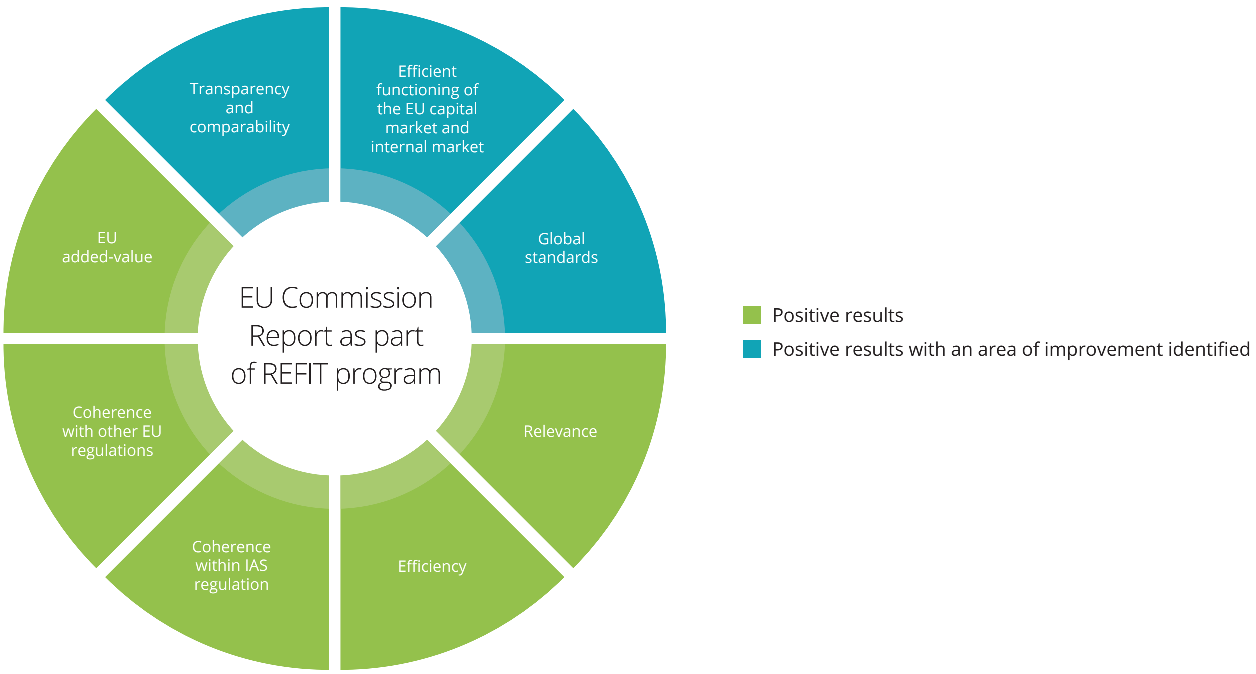
The assessment, published in 2015, considered the following topics:



1 Preface to International Financial Reporting Standard

2 Regulation EC 1606/2002 of the European Parliament and of the Council of 19 July 2002

IFRS adoption worldwide:

- IFRS required (for all or most of the companies)
- IFRS required (for Financial institutions only)
- IFRS authorized (option)
- Local Gaap required

In addition to that, while more and more countries are using IFRS, the United States still does not permit its domestic companies to use IFRS.

By contrast, IFRS are also seen as complex, and the sheer volume of disclosure may be perceived as having a negative effect on the ability of readers without specific training to understand the information provided, and therefore on the take-up rate. Some feedback also suggests that recent and frequent changes to these standards have adversely affected the cost/benefit trade-off.

In addition to that, while more and more countries are using IFRS, the United States still does not permit its domestic companies to use IFRS. Of course, this will significantly hamper international adoption the discrepancies that have emerged between IFRS and US GAAP, despite the initial intention to ensure convergence.

However, the EU has concluded that the benefits of implementing IAS/IFRS outweigh the costs and other drawbacks. A report published in 2017 by the IASB[3] about the worldwide adoption[4] of IFRS supports this positive stance.

Region	Number of jurisdictions profiled in the region	Of which requiring IFRS standards for all or most domestic publicly accountable entities
Europe	44	98%
Africa	23	83%
Middle East	13	100%
Asia-Oceania	33	73%
Americas	37	73%
Total	**150**	**84%**

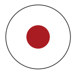
Source: IASB 2017

Of the 150 jurisdictions profiled, the IASB observed that 126 jurisdictions required IFRS for all or most companies (84 percent), as shown in the table on the left.

3 Pocket Guide to IFRS – The global Financial Reporting language

4 For domestic reporting by listed companies and for financial institutions

The adoption of IFRS in most jurisdictions around the world for domestic reporting, at least by listed companies and financial institutions, is seen as a real success.

Key Jurisdictions					
Financial Institutions	**IFRS** Mandatory if listed (if not listed, mandatory at least for FINREP and optional for statutory accounts)	**IFRS** Mandatory if listed (if not listed, mandatory at least for FINREP and optional for statutory accounts)	Prohibited (US GAAP is required)	Prohibited (only local GAAPs, but convergences with IFRS)	**IFRS** Allowed
Listed (non-financial) companies	**IFRS** Mandatory for consolidated accounts, and allowed for statutory accounts	**IFRS** Mandatory for consolidated accounts, and allowed for statutory accounts	Prohibited for domestic companies **IFRS** Allowed for foreign companies only	Prohibited (only local GAAPs, but convergences with IFRS)	**IFRS** Allowed
Unlisted companies & SMEs	**IFRS** Allowed (Either full IFRS or LuxGAAP with certain IFRS options or Fair value option. However, the IFRS for SMEs Standard is prohibited)	**IFRS** Allowed (Full application. However, the IFRS for SMEs Standard is prohibited)	Prohibited (However, the IFRS for SMEs Standard is neither required nor expressly permitted)	Prohibited (only local GAAPs, but convergences with IFRS)	Prohibited

Different interpretations/translations of IFRS:

- IFRS as issued by IASB
- IFRS as issued by EU
- IFRS as locally adopted
- IFRS as issued by IASB or EU

While most countries have enforced IFRS, some differences in implementation can be observed across jurisdictions. This may take the form of different interpretations/translations or simply modular/optional adoption in local law, introducing complexity for CFOs with companies in different countries.

A study conducted in 150 jurisdictions around the world by the IASB in 2017 highlighted this diversity across the IFRS environment (see graph for the proportion of each interpretation/translation of IFRS in the world).

A quick review of the most recently adopted IFRS—what, if anything, did it solve?

Since the last public consultation in 2014, the IASB has issued and the EU has adopted three major standards (IFRS 9, IFRS 15, and IFRS 16) with a view to increasing the efficiency of the EU capital market, and promoting transparency, comparability, and efficiency. Were these initial goals achieved?

Example #1:
IFRS 15 (Revenue from contracts with customers) aimed at harmonizing revenue recognition policies among market participants

This standard, issued in May 2014, with an equivalent under US GAAP (ASU 2014-09), entered into force on 1 January 2018.

The IFRS 15 model's core principle can be summarized as follows: to recognize revenue so as to document the transfer of promised goods or services to customers in an amount that reflects the performance obligations as described in the contract. Based on a scope decision tree, five steps are clearly defined in this revenue recognition framework, leading to a complete decorrelation with the cash records and with the invoicing process, fewer judgmental areas, and more guidance to align revenue recognition across countries, industries, and entities within the same sector.

Undoubtedly, IFRS 15 improves the consistency and comparability of revenue recognition practices, and the usefulness of disclosures, but does it imply changes in the role of the CFO?

As a result of a closer link with contracts and less scope for interpretation, the CFO may encounter more (or new) difficulties during audits. More supporting documentation may be required and, in some cases, contracts with customers are not explicit enough in their definition of performance obligations, leading to judgmental areas.

The CFO will therefore need to be part of upstream discussions on the (re)engineering of client contracts in order to prevent downstream flaws during the preparation of financial statements and audits, emphasizing the need for clarity in the description of performance obligations to clients. This is a clear indication of the increasingly important role of the CFO in providing business partnering in today's companies.

This may also accelerate the adoption of new technologies like smart contracts in the Blockchain comming at managing this types of constraints in a STP[5] way.

5 STP: Straight Through Processing

Example #2:

IFRS 9 (Financial instruments) aimed at reducing cyclical effects on systemic risk and avoiding "too little too late" risk

The former standard (IAS 39) was roundly criticized during the financial crisis for the pro-cyclical nature and lagging effect of its credit risk impairment model, the volatility affecting the income statement. This standard was also perceived as flawed in terms of comparability since it allowed some arbitrage in the classification and measurement rules on financial instruments, regardless of their complexity (some might say "toxicity").

Thus, the new IFRS 9 standard that has been in force since 1 January 2018—after a decade of back-and-forth discussions and amendments—aims to neutralize these negative effects.

Better comparability:

The classification and measurement method under IFRS 9 is now strictly based on:

01. The nature of the financial instrument (derivative or funded, equity or debt)
02. The contractual cash flows (complexity of the financial instrument, basic vs complex)
03. The business model (strategy envisaged by the entity for holding these instruments)

This leads to a stricter use of the amortized cost as measurement method for finacial reporting, as opposed to Fair Value that is promoted. Depending on the level of complexity for the products held on the balance sheet, some banks may already have experience of transferring some assets from fair amortized to value cost (or the other way around).Where IAS 39 allowed the same instrument to be accounted for under various measurement methods, under IFRS 9, the options available have been narrowed in order to ensure greater comparability.

However, it is worth to mention that having a larger part of the asset measure at Fair Value can lead to higher volatility and procyclicality except with a proper ALM and accounting policies.

For the CFO, this increased robustness in the classification process comes at the cost of greater involvement in the front-to-reporting process. Thus, the CFO now has an additional supervisory role (level 2) over the business lines and over the middle-office in charge of trade capture (or control). The purpose of this additional task is to ensure an acceptable level of alignment between IFRS 9 requirements and product classification in the information system, as well as monitoring its subsequent management.

Reduction of the "too little too late effect"

The most significant change introduced by the new standard relates to impairment accounting. IFRS 9 requires entities to estimate and account for ECL (expected credit loss) for all relevant financial assets and commitments no later than at initial recognition.

Expected loss provisioning was already required under the previous standard, often under the name of "incurred but not reported" loss allowance (IBNR reserve under IAS 39). However, the requirements on how to assess this loss allowance have changed considerably.

When designing the loss allowance (ECL), IFRS 9 promotes and requires:

- The "point-in-time" feature to ensure that ECL is sensitive to the economic cycle and to remove smoothing effects via the "though-the-cycle" rule used for regulatory capital. Consequently, the same asset (product) will have a different book value if reported at different points in the economic cycle (i.e., riskier assets are less valuable when macro-economic factors are below their long-term average, and a fortiori in the event of an economic meltdown).
- The "forward-looking" feature to avoid the lagging effects that are often caused by moving average methods and to ensure that asset values start to change before it is already obvious that they cannot be sold anymore at the book value (for instance).

For the CFO, there are two possible approaches to managing these new requirements:

- Stick to pure accounting responsibilities and take the ECL figures as they come, then rely heavily on other experts working for the institution, usually in risk teams
- Start to build a more comprehensive skillset within finance teams to monitor ECL figures, be in a position to challenge models or parameters, and explain variations on the balance sheet and in terms of profit and loss (sensitivity analysis, also called income attribution). While those charged with governance and the auditors are obvious clients, the business heads must also be included in the reporting line in order to ensure that they have the information they need to reach timely business and strategic decisions in line with changes in economic environment

At present, the finance-risk convergence is probably one of the hottest topics to address in banking organizations. Aside from providing accurate and sufficiently well-articulated information to ensure that financial statements can be understood by their intended readership, it is also a matter of managing talent within finance teams. IFRS 9 is encouraging clarity and providing a common language that the finance, treasury, and risk functions and the CFO can use to better communicate financial performance to investors, as well as internally to business line managers and to the Board of Directors.

In addition, the new standard requires (following the amendments to IFRS 7) that reporting entities make all useful public disclosures about credit risk exposure, credit risk management practices, provisioning, and related matters to bring about a higher degree of transparency. It is obvious that IFRS 9 bridges the gap between accounting and risk management—at least in theory. The real situation on the ground will depend on how the CFO (and the CRO) jointly reshape the organization in response to this challenge.

Example #3:
IFRS 16 aimed at increasing transparency with regard to commitments and avoiding arbitrage between owning an asset and having a long-term lease

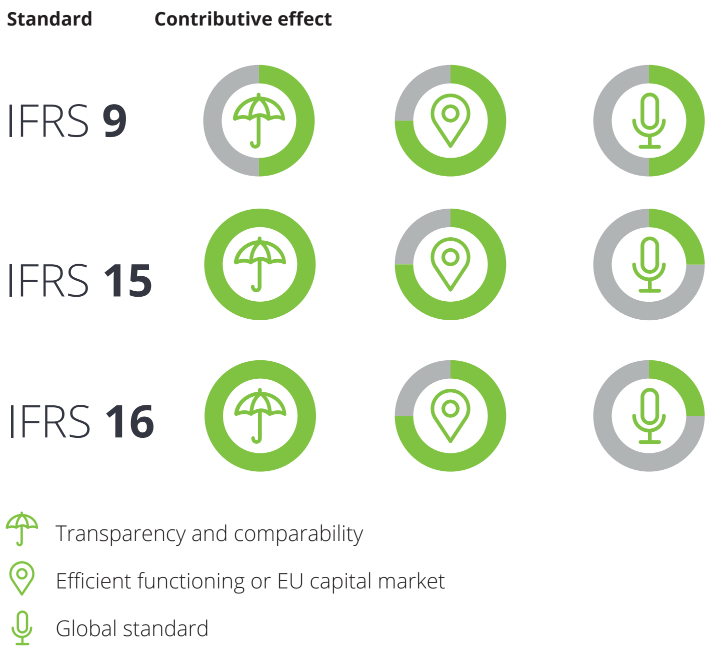
Leasing is an important financing activity for large corporate and financial institutions with the majority not reported on the balance sheet under IAS 17. That is because a significant part of the leases to date have been categorized (under the former standard for lessee) as "operating leases" (disclosed only in the income statement and in the notes to the financial statements as proposed to "Finance lease" reported on balance sheet).

This somewhat arbitrary distinction made it difficult for investors to compare companies. There was also criticism from investors that balance sheets provided a misleading picture about the leverage and leased assets used. This meant that investors (and other market participants) had to estimate the effects of a company's off-balance sheet lease obligations, which in practice often led to an overestimation of the liabilities arising from those obligations.

The new leasing standard removes the distinction between finance and operating leases for lessees, and enhanced guidance is introduced on identifying whether a contract contains a lease in order to increase the comparability of financial information (lessor accounting will not change significantly).

The new standard will have an impact on the monitoring of financial performance by the CFO as companies that have material off-balance sheet leases will report higher assets and lower equity when applying IFRS 16. As a company will present lease assets arising from leases of property, plant and equipment as tangible assets, this could affect the regulatory capital of lessees that are financial institutions. In addition, as higher liabilities will be presented, the CFO will have to closely monitor (and/or renegotiate) agreements if the company has loan covenants.

Standards and their contributive effects



Conclusion

The reaction of legislators/ standard-setters after the 2007 financial crisis has been to provide stakeholders, regulators, stock exchanges, rating agencies, and ultimately taxpayers with a greater level of transparency as regards financial information related to banking institutions. However, the amount of information currently disclosed has probably hindered rather than helped transparency and made IFRS understandable only for a limited number of specialists. The CFO is one of these rare specialists who can play a role in ensuring the correct degree of clarity in the financial reporting process.

While the new standards described above are making the reporting process more of a burden, they are also transforming the finance function from an end-user to a data setter either at the inception of the products/ services of the institutions or during their lifecycle through proper risk data aggregation. Implementing the right process for identifying criteria for recognition, classification, measurement, and disclosure, and maintaining the best possible related data warehouse, is the critical path for the next generation of CFOs.