Accounting, markets and global economic growth
Michel Prada, Shanghai National Accounting Institute, November 2014

Introduction

It is an honour to be with you today, at this most impressive of learning institutions. I see from your website that the Shanghai National Accounting Institute aims to become 'the world's leading accounting institute with international recognition'. From what I have seen, your facilities are already world-class. Moreover, few institutes anywhere in the world can claim to have trained more than 1.4 million accountants in little more than a decade. It would appear that you are making excellent progress towards achieving your admirable goal.

It is always a pleasure to be here in China, with the many friends and colleagues that I have the pleasure to work with. Let me begin by expressing my gratitude to the leadership and staff of the Ministry of Finance for their excellent support and co-operation. Earlier this year we welcomed Jin Liqun to the IFRS Foundation Trustees. Jin recently served as Chairman of the China International Capital Corporation. He succeeded Yong Li as an IFRS Trustee, who stepped down after being appointed as Director General of the United Nations Industrial Development Organization.

I also pay tribute to Dr Wei-Guo Zhang. As well as being a very effective member of the IASB, Wei-Guo has agreed to act as my tour guide this weekend when visiting the famous Terracotta Warriors of Xian. As you may know, Wei-Guo used to serve as a 'warrior of accounting' in his former role as Chief Accountant of the Chinese Securities Regulatory Commission, or CSRC. Wei-Guo and I are also old friends, as we worked together at IOSCO when I was a Securities Regulator.

My remarks to you this morning will cover three broad themes. First, I will set out the case for global accounting standards and, in particular, how the move to global standards has as much to do with sound economic policies as it does with accounting. Second, I will provide you with an update on the progress towards global accounting standards. And third, I will say a few words about China and IFRS.

The case for global standards

First, global accounting standards. I have witnessed and participated in many debates about accounting and accounting standards. The differing viewpoints are often rooted in different perceptions about the role of accounting in the global economy. On one hand, some view accounting in the form of traditional bookkeeping, recording transactions and providing the checks and balances to help in the orderly management of those businesses. Others view accounting, and, in particular, financial reporting as a communications exercise, providing investors and other market participants with high quality, decision-useful financial information.

Of course, the reality is that accounting serves both needs. This is especially true here in China, where the same set of Chinese Accounting Standards is used by private companies, as well as those listed on public markets. However, it is the latter—financial reporting being an exercise in financial communications—that has served as the primary driver for global accounting standards.

Advances in technology and a now globalised world economy mean that once isolated marketplaces are now fully interconnected, as demonstrated by the recent financial crisis. In the wake of the crisis, policy-makers are well aware that every national capital market in the world, even the largest, functions as a satellite of the global economic system. Fluctuations in market prices in New York and London are just as likely to be driven by prospects for Chinese economic growth as they are by events local to that jurisdiction—in some cases, more so.

The level of economic globalisation will only continue to grow. Recent research undertaken by McKinsey & Co indicated that more than one-third of all financial investments are, in fact, international transactions[1]. They concluded that the total volume of global flows could triple in the next decade, powered by a combination of rising prosperity, the participation of the emerging world and technological progress.

In such a globalised economic world, the investor and investee will often sit on different sides of the world. China is a great example of this. Many of China's largest companies are listed on both domestic and international markets, such as Shanghai, Hong Kong, London and New York. China is a prolific investor around the world, investing in a range of international companies and infrastructure projects. China is also benefiting from inward investment. Leading international companies are increasing their investment in their Chinese operations and activities and, in turn, contributing to the evolution and development of the Chinese economy.

This global market for capital has been an important feature of the world economy for several decades. However, it is particularly important today, because every major jurisdiction seeks to maintain a level of economic growth, to provide further time to heal the wounds from the global financial crisis and to facilitate a continued economic recovery.

The role of efficient markets is an economic policy objective for governments around the world. It is a central theme of China's 2020 reform programme that identifies the 'decisive role of markets' and the need to 'facilitate overseas companies' entry to China and Chinese companies' expansion abroad, including accounting and auditing'.[2]

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[1] McKinsey & Company (2014), *Global flows in a digital age,* www.mckinsey.com.

[2] China Daily (November 2013), *The Decision on Major Issues Concerning Comprehensively Deepening Reforms in brief*, www.china.org.cn.

The same focus on markets as part of the solution exists in Europe. The new European Commission recently announced its intention to create a 'Capital Markets Union' as a way to achieve a more healthy balance between bank-based and market-based financing, and in turn to unlock European economic growth.[3]

Within this context, accounting is much more important than just bookkeeping. In the same way that the World Wide Web provided global standards to power the information economy, policy-makers are increasingly looking to us, and to the people in this room, to deliver global standards for financial information to power the global economy.

When the investor and investee can be anywhere in the world, the method of communication between them has to be standardised. Even small differences in jurisdictional accounting requirements add friction to the global economy. They impede the efficient allocation of capital, which is an essential element of the global economic growth on which China and other major jurisdictions depend.

That is why I believe our work is so important. Together, we are pioneering a global language of financial information, on which our continued economic prosperity will increasingly depend. That is why the G20 Leaders, the International Monetary Fund, the World Bank, the Financial Stability Board and IOSCO have repeatedly expressed their support for our work and our mission of global accounting standards. Indeed, only two months ago the Financial Stability Board reaffirmed its commitment to "the continuing relevance of a single set of high quality global accounting standards."[4]

Progress towards global standards

The good news is that excellent progress has been made towards this important goal since we began our work back in 2001. What began a decade ago with the adoption of IFRS by Australia, Europe, Hong Kong and South Africa has now spread around the world.

According to our latest analysis, 114 of the 138 countries researched require the use of IFRS for all or most public companies. That is, four-fifths of the countries researched now mandate the use of IFRS. IFRS has become the prominent reporting system for most global industry sectors. These are remarkable statistics, given that little more than 10 years ago there were no major economies requiring the use of IFRS.

Of course, the remaining one fifth that have yet to require the use of IFRS for domestic purposes includes some very important countries, such as China, India, Japan and the United States.

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[3] European Commission (2014), *Mission letter to Jonathan Hill, Commissioner for Financial Stability, Financial Services and Capital Markets Union*, www.ec.europa.eu.

[4] Financial Stability Board (2014), *Press Release: FSB Plenary meets in Cairns, Australia*, www.financialstabilityboard.org.

It is also true that this calculation does not distinguish between countries that have retained their national GAAP and others, such as China, whose domestic standards are already similar to IFRS, but where differences in the standards remain. However, in each of these remaining jurisdictions, we continue to see good progress made towards IFRS and global standards.

In India, IFRS developments continue to move at pace. The new Indian Government recently announced its intention to transition to Indian Accounting Standards based on IFRS, although, like China, those standards may deviate from IFRS in some areas. We will work with our Indian colleagues to ensure that the differences are kept to a minimum. It is also important to many Indian companies that they continue to have the option to use full IFRS if they so wish.

Japanese companies have had the option to use IFRS since 2009. It is highly encouraging to see the number of companies making use of that option grow rapidly. As of today, 46 domestic Japanese companies with a combined market capitalisation of 63 trillion Yen have adopted, or announced plans to adopt, full IFRS. According to the annual reports of these companies, the top three reasons for transitioning to full IFRS were comparability with global competitors, the spread of their shareholder base and management efficiency. Use of full IFRS is one of the factors considered for the inclusion of Japanese companies in the recently launched JPX-Nikkei 400 Index—an index that, according to a recent article in the *Financial Times*, is very popular with international investors.[5]

In the US, it is fair to say that progress has been slower than anticipated. However, the use of IFRS in the US is more advanced than many realise. US investors are already prolific users of IFRS financial statements, holding more than eight trillion dollars of foreign holdings, most of which are denominated in IFRS. Also, the SEC oversees the IFRS-compliant financial statements of almost 500 international companies listed in the US. Those companies have a combined market capitalisation in the trillions of dollars—representing a significant market for US investors.

The SEC Chairman, Mary Jo White, has indicated in public forums that IFRS is a high-priority item for the SEC and that there is a need to provide some clarity on the SEC's position about the domestic use of IFRS in the US. We look forward to working with Jim Schnurr, the new SEC Chief Accountant, on this important topic.

China and global accounting standards

This brings me to China. China has been a long-term supporter of our work. You have been through two major accounting transitions; the first back in 1992 when you abolished the uniform accounting systems designed for the planned economy and built a modern accounting profession from scratch. And then a second time, when in 2006 you issued a new set of Chinese Accounting Standards that are similar to IFRS.

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[5] *Financial Times* (15 June 2014), *Japan groups take a shine to JPX-Nikkei 400 Index*, www.ft.com.

This represented a considerable undertaking for a country the size of China. It is also very impressive that these new standards are required for use by all large and medium-sized Chinese companies, not just listed ones. I understand from colleagues that the differences are very small between Chinese Accounting Standards and IFRS.

It is also often overlooked that Chinese companies representing more than 30 per cent of the total domestic market capitalisation in China also report using full IFRS for the purpose of their dual listings in Hong Kong, while Hong Kong has itself been fully on board with IFRS since the beginning.

Thus, China has undertaken a far-reaching modernisation of its accounting standards, while Hong Kong, as China's international financial centre, has adopted IFRS in full and without modification.

So, what next for Chinese accounting?

Well, we are committed to working in close co-operation with the Ministry of Finance as it updates Chinese Accounting Standards with the various new Standards issued by the IASB. This is important work, because many of these Standards have been introduced in the wake of the global financial crisis. We are also very appreciative of China's leadership in the IASB's Emerging Economies Group, its participation in the IASB's Accounting Standards Advisory Forum and its involvement in the Asia-Oceanian Standard-Setters Group. These are important developments and demonstrate China's desire to fulfil a leadership role in financial reporting internationally.

As a Trustee, I am keen to work with the Ministry of Finance on a funding mechanism that allows China to fully contribute to the costs of the IFRS Foundation. I am also keen to encourage Chinese support for our Asia-Oceania office in Tokyo. Our ambition is for the office to become an IFRS regional centre of excellence. In support of this objective, we have recently appointed a technical member of staff fluent in both Cantonese and Mandarin.

However, the greatest accounting challenge I see is that China has not fully received the international recognition it deserves by your efforts to move to global accounting standards. It is the same problem faced by any jurisdiction that chooses to adjust IFRS to meet local requirements. Other jurisdictions that have adopted IFRS in full and without modification often assume that the adjustments must be substantial to warrant such a change.

Of course, from the point of view of the IFRS Foundation, we think China is in a position to adopt full IFRS by eliminating minor differences and we would welcome China becoming a full IFRS adopter, thus benefiting from full international recognition of its accounting standards.

Conclusion

Ladies and gentlemen, distinguished colleagues, I am grateful for your attention.

China deserves great credit for the modernisation of its accounting systems. Institutions such as this provide a clear signal to the world of China's ambition to be a world leader in accounting and financial reporting.

At the same time, policy-makers around the world recognise the need for markets to play a more central role in financing the continued global economic growth. Reducing friction in those markets is the central driver of global accounting standards, and I believe it is in China's economic interests to complete its transition to full IFRS, and in doing so reap the benefits and international recognition that come with IFRS adoption.

I thank you for your time, and look forward to your questions.