EUROPEAN COMMISSION PUBLIC CONSULTATION ON THE GREEN PAPER *BUILDING A CAPITAL MARKETS UNION*

A paper by the IFRS Foundation on the financial reporting implications

May 2015

<u>Introduction</u>

1. The purpose of this paper is to provide a perspective from the International Financial Reporting Standards (IFRS) Foundation (the Foundation) and its standard-setting body, the International Accounting Standards Board (IASB) on the financial reporting implications of the European Commission's Green Paper *Building a Capital Markets Union* (CMU), in particular the question (number 8) on whether there is "value in developing a common EU level accounting standard for small and medium-sized companies listed on Multilateral Trading Facilities (MTFs)".

2. This paper sets out the Foundation's views:
   a. of the importance of taking account of the global context and the dual benefits of having international - as well as EU-wide - comparability in financial reporting requirements (paragraphs 4-7);
   b. that companies who enter public capital markets are publicly accountable, regardless of size, a view that is shared in other major capital markets around the world; together with the importance of meeting the needs of investors (paragraphs 8-16);
   c. that a single set of financial reporting Standards is appropriate for all listed companies (paragraphs 17-19);
   d. that there are circumstances where it is appropriate for different financial reporting requirements to apply to different categories of companies (paragraphs 20-26).

3. While this paper sets out our current position on the financial reporting issues raised in the Green Paper, **the Foundation and the IASB stand ready to work with the European Commission, and our other constituents (including the users of financial statements) in considering the financial reporting implications of the CMU.**

<u>Setting the global context: the importance of international comparability</u>

4. The Green Paper seeks views on whether there should be common EU level financial reporting requirements as part of the CMU. In its October 2014 response to the European Commission's consultation on the effects of using IFRS in the EU, the Foundation commented that the use of a single set of financial reporting requirements is

essential to the successful achievement of a CMU[1]. That remains the Foundation's position. But the Foundation also believes that the benefits of having a single set of requirements will not be fully realised unless those requirements are applicable across the globe. The Green Paper also specifies that, given the global nature of capital markets, one of the key principles on which to base a CMU is that it should help to attract investment from all over the world and increase EU competitiveness. The Foundation strongly supports this view and believes that, in order to achieve this, the financial reporting regime must provide for transparent and reliable financial information that is comparable internationally. This was a factor that led to the adoption of the International Accounting Standards (IAS) Regulation (1606/2002) in 2002.

5. The importance of that international comparability continues to be stressed. For example, the Maystadt Report in 2013 observed a "wide consensus among stakeholders on the commitment to global quality accounting standards", with the global character of IFRS being the most significant factor[2]. The Foundation's review of the responses to the Commission's public consultation in 2014 on the effects of using IFRS in the EU also reveals the importance that stakeholders attach to the establishment of a single set of globally accepted high-quality financial reporting standards[3]. IFRS has the twin advantage of being the single financial reporting language both for the EU and for the world at large.

6. IFRS is applied across the world, with 116 jurisdictions mandating the use of IFRS for all or most public companies and 14 more permitting its use[4] - market participants around the world are familiar with and use IFRS. The use of IFRS in the EU already contributes to the promotion of Europe as an internationally competitive and attractive place to invest. The global reach of IFRS and the positive effects that it has brought in terms of the quality, transparency and comparability of financial reporting is core to this promotion. The use of IFRS in the EU also helps EU companies in seeking capital and investment in third countries. In addition, the use of IFRS globally by EU companies, without the need for reconciliations, has provided them with the benefit of achieving improved group reporting and administrative savings through having to report only under one accounting framework.

[1] The response can be accessed at: http://ec.europa.eu/internal_market/consultations/2014/ifrs/docs/contributions/individuals-and-others/ifrs-foundation_en.pdf.

[2] Philippe Maystadt (October 2013) *Should IFRS Standards be More "European"?: Mission to reinforce the EU's contribution to the development of international accounting standards*, available at: http://ec.europa.eu/finance/accounting/docs/governance/reform/131112_report_en.pdf.

[3] For example, an April 2015 by Bruegel *Capital Markets Union: A Vision for the Long-Term* suggests that "as an indispensable complement to its CMU agenda, the EU should champion international financial regulatory standards and other global initiatives as it has done previously – not lease in its landmark adoption of IFRS a decade ago" (page 16), at: http://www.bruegel.org/publications/publication-detail/publication/878-capital-markets-union-a-vision-for-the-long-term/.

[4] Details can be accessed at: http://www.ifrs.org/Use-around-the-world/Pages/Analysis-of-the-IFRS-jurisdictional-profiles.aspx.

7. The use of IFRS for companies listed on MTFs will ensure these benefits are extended. Any alternative accounting framework that might be contemplated would be challenging if it does not ensure a similar level of international understanding and acceptance.

Public accountability and meeting the needs of investors

8. Experience around the world shows that a key factor to the success of capital markets is the level of trust placed in them by investors. In considering the development of a CMU, the European Commission needs to consider steps and policies that will promote that trust, including the use of an internationally accepted set of financial reporting Standards. As the Foundation's *Mission Statement* makes clear, our work "serves the public interest by fostering trust, growth and long-term financial stability in the global economy"[5].

9. The Green Paper refers to the key role that IFRS has played for promoting a single accounting language for the EU for large listed EU companies. However, in relation to smaller companies wanting access to dedicated trading venues such as MTFs, we note that the Green Paper refers to full IFRS as "a source of additional cost", but without any mention of the benefits that the use of IFRS brings.

10. The application of IFRS does require a company to incur the costs of preparing financial statements, but the Foundation views this as a necessary investment in the light of that company's decision to enter a public capital market. Such markets, whether regulated markets or MTFs, bring together companies that seek capital and investors who are not involved in managing the company and who are considering whether to provide capital, and at what price. Those investors do not have the power to demand the financial information they might find useful for investment decision-making and so must rely on general purpose financial statements. A company's decision to enter a public capital market makes it publicly accountable, regardless of size. In this circumstance, the company must provide the outside debt and equity investors with a broader range of financial information than may be needed by users of financial statements of companies that obtain capital only from private sources.

11. The Foundation is not aware of any hard evidence that suggests that the costs of application of IFRS are unmanageable. The European Commission's report in 2008 on the operation of the IAS Regulation[6] noted, on the evidence of a 2007 study by the Institute of Chartered Accountants in England and Wales (ICAEW)[7], that while smaller quoted companies faced more difficulties in applying IFRS because of limited resources

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[5] The *Mission Statement* can be accessed at: http://www.ifrs.org/About-us/Pages/IFRS-Foundation-and-IASB.aspx.

[6] European Commission (2008) *Report on the operation of Regulation 1606/2002 on the application of international accounting standards*, at: http://ec.europa.eu/finance/accounting/docs/ias/com-2008-0215_en.pdf.

[7] ICAEW (2007) *EU Implementation of IFRS and the Fair Value Direceive*, at: http://ec.europa.eu/internal_market/accounting/docs/studies/2007-eu_implementation_of_ifrs.pdf.

and a lack of prior experience of IFRS, the level of implementation and recurrent application costs "remains an acceptable level". Elsewhere, evidence of the Canadian transition to IFRS reveals that costs were "significant, but manageable" and that for smaller listed companies, the transition to IFRS was "generally straightforward"[8]. The application of IFRS is straightforward when a company's business model is simple. The costs of application are greater where a company's business model is complex, but those costs are necessary in order for the company to provide investors with a faithful representation of that complexity.

12. The Foundation observes that other jurisdictions with major capital markets regard all listed companies, regardless of size, as being publicly accountable and so require them to apply the full suite of applicable financial reporting standards. This is the case, for example, in Australia, Canada, Hong Kong and Korea, where full IFRS[9] is applied by all listed companies. It is also the case in the US, where all domestic companies whose debt or equity securities trade in a public market are required to follow US Generally Accepted Accounting Principles (US GAAP), regardless of their size. The Green Paper uses the US as the primary example of a jurisdiction where there is greater use of the capital markets, noting in the Foreword that in the US "medium-sized companies, the engines of growth in many countries, receive five times more funding from capital markets than they do in the EU".

13. In the US, smaller listed companies are provided with relief from regulatory requirements other than the financial reporting standards to be applied. For example, in September 2010, the US Securities and Exchange Commission (SEC) issued a final rule for 'non-accelerated filers' (smaller issuers)[10] an exemption from obtaining an independent auditor's report on the effectiveness of their internal control over financial reporting under Section 404(b) of the Sarbanes-Oxley Act 2002. As another example, the US Jumpstart Our Business Startups (JOBS) Act 2012 created a new category of issuer, called an emerging growth company (EGC), and provides regulatory relief to EGCs to encourage Initial Public Offerings (IPOs). One of the reliefs available to EGCs allows for an extended phase-in for the application of new or revised accounting standards. However, an EY report in 2014[11] reveals that less than 20% of EGCs have elected to retain the ability to delay the effective date of new or revised accounting standards. The report notes that it appears that many EGCs want to reassure investors that their financial statements will remain comparable with those of other public

[8] FEI (2013) *The Cost of IFRS Transition in Canada*, at: https://portal.feicanada.org/enews/file/CFERF%20studies/2012-2013/The%20cost%20of%20IFRS%20transition%20in%20Canada%20-%20July%204,%202013%20-%20final.pdf.

[9] HKFRS in Hong Kong, which is identical to IFRS.

[10] SEC Final Rule Release No 33-9142 *Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers*. While non-accelerated filers is not a defined in Commission rules, it refers to issuers that have aggregate worldwide market values of voting and non-voting equity of less than US$75 million, as of the last business day of the issuers' most recently completed second fiscal quarter. Available at: https://www.sec.gov/rules/final/2010/33-9142.pdf.

[11] EY (August 2014) The JOBS Act: 2014 mid-year update - An overview of implementation and an analysis of emerging growth company trends, page 13. Available at: http://www.ey.com/Publication/vwLUAssets/EY-the-JOBS-Act-2014/$FILE/EY-the-JOBS-Act-2014.pdf.

companies. EGC registrants can also prepare IPO registration documents with less financial statement disclosures than other registrants, for example by providing only two years of audited financial statements rather than three years. There is evidence that such reduced financial statement disclosures have unintended consequences for registrants in the form of higher accounting fees, lower valuations and lower assessments of intrinsic value by investors[12].

14. The application of US GAAP by such companies does not, therefore, appear to have been a barrier to growth in the US markets, with a total of 275 IPOs taking place in 2014, the highest total since 2000[13].

15. Any proposal to develop a common accounting standard for SMEs listed on MTFs, in particular SME Growth Markets (SME-GMs), will therefore need careful consideration, given that such companies are publicly accountable. The Foundation notes that, in this context, the definition of SMEs as set out in the Markets in Financial Instruments Directive (Directive 2014/65/EU, MiFID II) encompasses some sizeable companies, with an average market capitalisation over a three-year period of up to €200 million.

16. Public accountability requires those companies to prepare and publish financial information that is compiled in accordance with financial reporting standards that are viewed by market participants as being credible, authoritative, comparable and familiar to investors (in particular where companies are seeking to raise funds outside their home Member State). As the Green Paper also acknowledges, a key principle of a CMU should be to ensure an effective level of investor confidence and protection, including through the financial reporting standards to be applied. IFRS meets all these requirements. Any alternative financial reporting regime contemplated by the European Commission would also need to meet these requirements.

<u>A single set of financial reporting Standards for all listed companies</u>

17. The Foundation believes that many entities which seek to have their securities listed on non-regulated markets do so in the expectation that they may eventually seek a listing on a regulated market. This is particularly the case where the purpose, and consequently limitation, of the non-regulated market is premised on the size of the participant entity, rather than the nature or type of its business activity. This implied mobility suggests these entities would benefit from the application of if not the same, then a similar financial accounting framework on both regulated and unregulated markets. The same, or a similar, Financial Reporting Standard framework would allow entities to move between markets with limited or no changes to systems, would facilitate any prelisting

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[12] Westfall, Tiffany J. and Omer, Thomas C. (2015) *The Unintended Consequences of Emerging Growth Company Status on IPO: Auditor Risk and Effort, Valuation, and Underpricing*. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2512605.

[13] Renaissance Capital's *2014 US IPO Annual Review*, available at: http://www.renaissancecapital.com/news/renaissance-capitals-2014-us-ipo-annual-review-22514.html.

information requirements and would allow those entities to maintain and present a historical set of meaningful, verified comparatives.

18. Entities listed on non-regulated exchanges frequently compete for investment funds with entities that are listed on regulated markets. Investors frequently invest in both regulated and unregulated markets, and make their investment decisions based on comparisons of investment performance across both platforms. Since many investees listed on non-regulated exchanges differ from competitors listed on regulated markets only in terms of size, and not in terms of either nature or type of business activity, such comparisons are valid and would benefit from the application of a single or a similar accounting framework.

19. Consequently, it is the view of the Foundation that there is benefit to be sought in applying the same financial accounting framework to entities on both regulated and unregulated markets, or having a similar framework that minimises any differences. This facilitates both comparability and mobility.

Public accountability and differential reporting

20. The proposal for having differential reporting for different categories of companies is not new. Indeed, the IASB has established its own differentiation with the issue in 2009 of the International Financial Reporting Standard for Small and Medium-sized Entities (*IFRS for SMEs*). The publication of the *IFRS for SMEs* represented the culmination of a project began by the IASB shortly after its inception in 2001, which included two major rounds of consultation, together with further outreach activities and field tests.

21. The primary objective of the IFRS Foundation, as set out in its *Constitution*, is "to develop, in the public interest, a single set of high quality, understandable, enforceable and globally accepted standards based on clearly articulated principles". The *Constitution* also specifies another objective of the organisation as being "to take account of, as appropriate, the needs of a range of sizes and types of entities in diverse economic settings". In considering these two objectives together, the IASB has stated that "single set" means that all entities in similar circumstances globally should follow the same standards, but that circumstances can differ depending on the type and size of entities[14]. This explains the IASB's rationale in developing a separate reporting framework for SMEs.

22. In developing the *IFRS for SMEs*, the IASB concluded that the Standard is intended for use by entities that do not have public accountability. An entity has public accountability if its debt or equity instruments are traded in a public market, or if it is in the process of issuing such instruments for trading in a public market, or if it holds assets in a fiduciary

[14] *IFRS for SMEs* (2009) Basis for Conclusions, paragraph BC42.

capacity for a broad group of outsiders as one of its primary businesses. The IASB decided that it would not be appropriate to define an SME by reference to quantified size criteria .This is because the IASB believes it is not practicable to develop quantified size tests that would be applicable across numerous countries.

23. As part of its recent review of the *IFRS for SMEs*, the IASB considered whether some or all publicly accountable entities should be permitted to apply the standard. The IASB observed that the *IFRS for SMEs* was specifically designed for SMEs and users of SME financial statements. In contrast to non-publically accountable entities, public investors and stakeholders generally are not involved in managing the business and do not have the power to demand information that they might find useful for investment decision-making. They must rely on general purpose financial statements. Many of the simplifications, expedients and reduced disclosure requirements in the *IFRS for SMEs* were premised on this understanding

24. As a consequence, the IASB noted two interrelated reasons for not allowing publically accountable entities to use *IFRS for SMEs*:

    (a) if the scope was widened to include some or all publicly accountable entities, this may lead to pressure to make changes to the *IFRS for SMEs* to accommodate that wider group, which would increase the complexity of the standard. Even excluding concerns that may be raised from other interested parties, the Board noted that in its own deliberations, it would be difficult, if not impossible, to ignore the existence of public users of a sub-set of financial statements prepared under *IFRS for SMEs*;

    (b) there are specific risks associated with the inappropriate use of the *IFRS for SMEs*. The Board noted that if publically accountable entities were allowed to use *IFRS for SMEs*, and, as a consequence of not being the intended user group, were producing financial statements of insufficient quality or usefulness, this would have the effect that a sub group of financial statements, prepared under the brand of the IFRS, would essentially not be fit for purpose. This would have the consequence that some financial statements produced applying the requirements of an IFRS would not meet the objectives of the Foundation.

25. As part of the review of the *IFRS for SMEs*, the IASB consulted the IFRS Advisory Council and its specialist SME Implementation Group (SMEIG). A majority of members of both groups shared the IASB's concerns and recommended keeping the requirement in the *IFRS for SMEs* that prevents publicly accountable entities from stating compliance with the *IFRS for SMEs*.

26. The IASB concluded that the present position should be maintained and that the scope of the *IFRS for SMEs* should remain restricted to non-publicly accountable entities. An

entity with public accountability should use the full suite of IFRS. That said, jurisdictions can incorporate the *IFRS for SMEs* into their local GAAP if they wish to allow certain publicly accountable entities to use it. However, those entities would state compliance with local GAAP, not with the *IFRS for SMEs*.

Next steps

27. As noted in the introduction to this paper, the Foundation and the IASB stand ready to work with the European Commission, and our other constituents (including the users of financial statements) in considering the financial reporting implications of the CMU.