European Securities and Markets Authority

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Keynote Speech

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Ladies and Gentlemen,

It is a pleasure to be here today at the E&Y *Financial Reporting Outlook* conference. I am delighted to see that you have attracted such a large group of speakers and participants with practical experience of IFRS.

Today we are now more than six years away from the 2007 start of the financial crisis and it seems as though financial supervisors, central banks and governments have been in a permanent state of 'fire-fighting'. The crisis triggered improved co-operation at G20-level and led to a wide range of policy decisions aimed at reforming Europe's and the world's financial system.

The European Securities and Markets Authority (ESMA)

The establishment of the European Securities and Markets Authority (ESMA), together with the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA) forms part of the European Union's ambitious legislative and regulatory response to the financial and economic crisis. ESMA's five main objectives and tasks are:

(1) creating a single rulebook across the EU;
(2) supervision of credit rating agencies and trade repositories;
(3) supervisory convergence in EU securities law application;
(4) investor protection; and
(5) financial stability in the EU.

The mandate of ESMA applies to a broad range of financial activities in Europe's securities

markets, from trading complex derivatives to hedge funds, the supervision of entities with a key role in financial markets – such as credit rating agencies and trade repositories – to the management of investment funds and their sale to the public. In essence, all of ESMA's work contributes to investor protection and stable EU financial markets.

While this may seem a daunting task, I believe that ESMA has performed well over the last three years in delivering high quality work to challenging deadlines and with limited resources.

One of ESMA's main tasks, unique amongst the three European Supervisory Authorities, is the supervision of key market players, with our main focus being on credit rating agencies. ESMA has developed an effective supervisory regime, and conducted significant on-site supervisory work with CRAs, most recently on bank rating methodologies, structured finance and sovereign debt ratings. ESMA now supervises 22 CRAs, with three new entities registered in the last 12 months, and we are confident that direct EU supervision is effective and has helped improve the functioning of CRAs.

Another major area of progress is in relation to EMIR, the EU's response to the risks posed by OTC derivatives. We have produced the technical standards necessary for EMIR's implementation, started to consult on the clearing obligations for the different types of derivatives, begun the recognition process for third-country CCPs and have announced the first four registrations of trade repositories. This will see ESMA take on further supervisory responsibility as well as starting the clock for the reporting of derivatives trades. Additionally, we have cooperated with our global counterparts in ensuring that the different regional regimes can operate as harmoniously as possible.

Financial reporting

So far I have not said anything yet on the topic of today's agenda, financial reporting, but wanted to benefit from the approach the organisers have taken and outline for you the wider context in which we operate. Let me now move on to financial reporting and what ESMA does in this area.

The supervision and the potential subsequent enforcement actions regarding financial reporting are carried out at national level. The direct interlocutor for listed companies is therefore the national competent authority such as the Financial Conduct Authority (FCA) and the Financial Reporting Council (FRC) here in the United Kingdom. ESMA however has a clear mandate to

enhance supervisory convergence and ensure consistent application of International Financial Reporting Standards (IFRS) in the EU.

ESMA does so by coordinating national enforcement activities and actions primarily through the European Enforcers Coordination Sessions (EECS), gathering national accounting enforcers on a regular basis to discuss enforcement cases and to identify issues that need further coordination or action at European level in order to improve the quality of financial statements.

This brings me to my main message of today: we need to further improve the quality of financial statements. I believe, that while a lot has already been achieved in this area, further progress is necessary and, being honest, this will be a continuous effort in a changing environment.

Therefore, I will begin by touching upon the need for transparency and explaining what that means for this year's financial statements based on what we saw as part of our monitoring and enforcement experience. To conclude I will say something on how Europe is adopting IFRSs.

The crisis showed us that there was – and in some cases, that there still is – little visibility on the risks that companies are exposed to. Transparency is one of the main and most important principles guiding securities regulators in their response to the financial crisis. This has in turn triggered many policy decisions aimed at reforming the financial system with pressure being applied to international bodies such as the International Accounting Standards Board (IASB) to accelerate their agenda.

Though there is a clear need for better regulation, and we fully support these initiatives, I think we should not create the impression that we can legislate for every possible scenario. The IASB cannot develop IFRS capable of capturing all the necessary disclosures for any company around the world.

Financial statements are seen as becoming irrelevant, too lengthy, too detailed and too burdensome for preparers to make. Perhaps more than legislative changes or more standards we need to develop a different mind-set.

Companies and auditors need to apply judgment on the basis of principle-based standards. Securities regulators and accounting enforcers are criticised for asking for more disclosures, the

argument being that this is the reason for overly long reports that are inaccessible for investors. Our emphasis on disclosure is not because we believe that disclosure could replace the recognition and measurement principles, but because it allows issuers to provide investors with high-quality information within a principles-based environment.

A query from an enforcer is an invitation for an issuer to explain its judgments in omitting a disclosure and not necessarily an indication that it should be included in the financial statements. A principles-based environment can however only survive if clear and entity-specific disclosures, re-assessed at the end of each reporting period, bring relevant decision-useful information to investors by presenting the judgements that had most significant effects on the amounts recognised in the financial statements. If not, detailed prescriptive requirements would need to be developed and we all know that what is important today will not necessarily be so in the next financial year.

The only way to avoid this is for issuers to stop providing boilerplate information mimicking the standards. Clear and decision-useful information is what we need. In other words, genuine transparency.

Common Enforcement Priorities

ESMA issues on a yearly basis *common EU enforcement priorities* highlighting the areas on which all EU enforcers will focus when reviewing that year's financial statements. We have done that for the first time in 2012 and we consider it as a very useful tool to communicate with market participants (preparers, auditors and investors).

Based on the current and expected economic context the issues have been grouped around five themes: (a) impairment of non-financial assets/ goodwill; (b) measurement and disclosure of post-employment benefit obligations; (c) fair value measurement and disclosures; (d) disclosures related to significant accounting policies, judgements and estimate (which I just mentioned before) and last, but not least (e) measurement of financial instruments and disclosure of related risk, which are particularly relevant for financial institutions.

The common enforcement priorities will be published today. I will focus on the first three ones here and will cover the other ones in more detail later when speaking about our recent work on financial institutions.

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- *Impairment of non-financial assets*: the economic situation over the last years increased the likelihood that the carrying amounts of assets might be higher than their recoverable amounts. The market value of many listed companies has fallen below their book value, a situation potentially indicating impairment and thus the need for an impairment test.

  ESMA published earlier this year a study showing significant shortcomings in areas related to the goodwill impairment test. In the 2012 economic context only one third of the issuers we examined recognized impairment losses, 80% of those issuers are using value in use, and 20% apply a terminal growth rate higher than 3% - which is an interesting figure in the current economic environment!

  Unfortunately we have not seen sufficient progress in the way companies report since then and impairment is still too often not sufficiently and correctly addressed in the financial statements. Investors need more information on the reasonableness of cash flow projections and key assumptions used by management in determining value in use. In our opinion investors also need a sense of the safety margins that an entity has and believe that meaningful sensitivity analyses are very useful information tools.

- *Defined benefit obligations*: the continued numerous debt downgrades over the last year increased the debate on the existence of a deep market in high quality corporate bonds and to which market discounted post-employment benefit obligations should be referenced. ESMA asked the IFRS Interpretations Committee to clarify this issue. The IASB tentatively decided to amend IAS 19 – *Post-Employee Benefits* to clarify that the depth of the bond market should be assessed at the currency level (for the entire euro-zone: the euro) and not at the country level. Now, we expect issuers to use an approach consistent with this clarification and we believe this should be less problematic for this year end. We also think it is important that entities are presenting the actuarial assumptions used in their valuation and their sensitivity analyse s, which are particularly relevant for groups with large pension schemes.

- *Fair value*: there have been numerous discussions with respect to fair value measurement issues as there seems, in general, to be a lack of transparency. Measurement bases cannot always be well understood from what companies present in their accounts. The IASB's new

standard (IFRS 13 – *Fair Value Measurements*) relevant for items measured at fair value by a company (such as real estate properties, so not only relevant for banks) will be helpful in this respect.

We think it is important that issuers apply this standard in the right way by providing enhanced disclosures and transparency on the valuation methodologies and the classification in the fair value hierarchy. We should not forget the debate that took place during the crisis on the fair value measurement hierarchy in the context of active/non-active markets and the use of inputs for level 3 measurements. The more unobservable data are included in the measurement of fair value, the more important it is for users to understand the underlying uncertainties. Including a description of the sensitivity to changes in unobservable inputs if a change in those inputs might result in a significantly different fair value measurement, is relevant information for investors.

Financial institutions

Let me move on to financial institutions which have been at the centre of attention through the entire crisis – banks, and in particular European banks, many of whom will soon be subject to the supervision of the European Central Bank under the single supervisory mechanism.

Before assuming full responsibility the ECB will assess the banks that will come under its supervision. The assessment will consist of three elements:

i.) a supervisory risk assessment to review, quantitatively and qualitatively, key risks, including liquidity, leverage and funding;
ii.) an asset quality review (AQR) aiming to enhance the transparency of bank exposures by reviewing the quality of banks' assets, including the adequacy of asset and collateral valuation and related provisions; and
iii.) a stress test to examine the resilience of banks' balance sheet to stress scenarios.

The assessment is an important step in the preparation of the single supervisory mechanism and towards greater transparency of the banks' balance sheets – which is crucial for market confidence.

In December 2012, ESMA issued a statement underlining the importance of the correct

measurement and additional transparency on the impact of forbearance activities. Since then forbearance activities have been a priority for European IFRS enforcers.

ESMA is about to publish a study for which we looked at the financial statements of 39 European financial institutions to assess comparability between institutions, overall transparency and compliance with IFRS requirements. Though there have been many efforts to improve the quality of financial statements, you will see that the lack of information, and divergences among issuers we have noted in some areas, are disappointing.

Three key messages for financial institutions and – not to forget: their auditors, are therefore:

1) We observed a wide variability in the quality of the information provided and identified cases where the information provided was not sufficient or not sufficiently structured to allow comparability among financial institutions. For example, regarding impairment of equity instruments classified in the so-called available-for-sale category, a number of institutions did not provide any information. Others provided ambiguous disclosures on how they applied 'significant or prolonged criteria' suggesting the use of a combination of significant *and* prolonged.

   More than half of the financial institutions quantitatively disclosed what they consider significant or prolonged. However, ESMA found ranges from 6 to 36 months in relation to the time period and from 20% up to 50% in relation to the decline in fair value.

2) Although more financial institutions provided information on forborne financial assets compared to the 2011 IFRS financial statements, there is a need for more granular quantitative information on the effects of forbearance that would enable investors to assess the level of credit risk related to forborne assets and their impact on the financial position and performance.

3) More generally, we hope that issuers will enhance their disclosures on exposure to credit risk, its mitigation (e.g. by collateral, guarantees or credit default swaps), analysis of specific concentrations of credit risk and disclosure of impairment policies in order to enable investors to assess overall credit risk. There is still too much unclarity in the area of liquidity and funding risk, asset encumbrance and fair value measurement of financial

instruments.

The report will be issued in the coming days and I believe that it contains many good elements to be considered when preparing the 2013 year-end accounts. Transparent financial statements providing a true and fair reflection of a financial institution's position and performance will contribute to the ECB's upcoming asset quality review. This is not to make any particular remark on what could come out of that exercise, but just to emphasise that even as banks have improved the quality of their accounts over the last year, there are still elements needing further improvement, with respect to measurement or disclosures, which are key for market confidence.

EU governance in the financial reporting area

Coming to the end of my speech I would like to touch upon an area that is perhaps further away from daily practice but that is nevertheless very important for all of us: the development of IFRSs by the IASB and their endorsement within the EU in the public interest.

With financial markets becoming more and more global, ESMA is a strong supporter of global financial reporting standards and believes they contribute to investor protection, and ultimately economic growth. The EU took a very bold step when adopting IFRSs in 2002 even if some important jurisdictions, like the US, have not taken them on board.

IFRSs have however been criticised by some as an accelerator or even the root of the financial crisis, mainly because of the use of fair value for some types of financial instruments and volatility created in the profit or loss accounts of companies. There are however many myths about fair value and looking back at, for example, the issues the EU experienced around the Greek sovereign bond crisis in 2011 and 2012, we can see that in such conditions fair value works better than the amortised cost model.

The crisis has however demonstrated the truly global nature of capital markets and the urgent need for global mechanisms to regulate the markets, including a single set of high quality global accounting standards. The IASB is doing important work, in some cases together with the US FASB, in order to enhance the resilience of the financial system. A process that is characterised by trial and error, successes and challenges.

This should however not lead to give up the ideal of coming to global standards adopted

throughout the world. We need to continue to invest, at global level but especially also at European level, in mechanisms that make our companies and investors benefit from global standards but by ensuring that the European voice is heard and that standards are developed within the public interest.

Currently there are about 7000 EU listed companies using IFRSs. This needs to be reflected within the governance model of the entire IFRS Foundation, including the IASB and the Monitoring Board. Concerns raised by the European Union should be heard and dealt with, something that only can be achieved with a credible and robust IFRS endorsement mechanism.

IFRSs are not the only piece of European financial legislation that is developed by an other body than the European Commission and that needs to be transposed into the EU legal system. Many parts of EU financial legislation are nowadays prepared by, or based on advice from, the three new ESAs. Hence, drafting legislation or providing advice for financial legislation is in these areas a responsibility given to public authorities, to ensure that the public interest is also embedded in technical legislation and technical advice. ESMA believes that financial reporting should follow similar rules and processes as other areas of financial markets regulation.

Yes, it is ESMA's view that endorsement of IFRSs should be entrusted to a body that operates by its constitution in the public interest and respects the following principles:

1) ensuring independence from private stakeholders' interests which has been identified as a significant weakness of the current system. Of course, this independence does not preclude in any way extensive consultations of market participants as part of the regulatory process;
2) ensuring that all EU Member States are represented; and
3) ensuring proper interaction with existing European authorities playing an important role in the area of financial reporting.

You will be aware that Commissioner Michel Barnier asked Philippe Maystadt to compile a report on the governance framework around the EU endorsement mechanism. His report explores various options in relation to the body which should provide endorsement advice to the Commission, and recommends the use of the current EFRAG structure with some changes in terms of governance in order to transform it from a fully private body to a structure with some more prominent public interest elements. However, I believe it is important to ensure that its

governance should be subject to more significant changes which should follow the principles I have just mentioned before. Therefore, we hope that the Commission will ensure that these principles will be taken into consideration when putting forward its proposals.

Finally, I would like to say that ESMA, in line with its mandate regarding financial reporting, must play an important role in financial reporting enforcement and we want to ensure that enforceability matters are considered as part of the standard setting process. Therefore, we look forward to seeing how in the proposed new framework we can fulfil that mandate.

Ladies and gentlemen, thank you very much for your attention.