



Federation of European Accountants
Fédération des Experts comptables Européens

1 April 2009



LETTER OF COMMENT NO. 11

Mr. Adam Van Eperen
Financial Crisis Advisory Board
c/o IASB
30 Cannon Street
GB - LONDON EC4M 6XH

Ref. FRP/SS/SL

Dear Mr. Van Eperen,

Re.: Financial Crisis Advisory Group – Request for Input

- (1) FEE (the Federation of European Accountants) is pleased to provide you with its considerations and responses to the questions raised by the Financial Advisory Group on accounting and reporting matters related to the financial crisis.
- (2) FEE shares the widely expressed concerns on the serious and disruptive implications of the financial crisis whereby many parts of the financial systems have come under severe strain and still remain so to date. Some of these concerns relate to financial reporting matters and therefore, we commend the initiative of the Financial Crisis Advisory Group to consult with a wide range of stakeholders on accounting and reporting matters related to the financial crisis.
- (3) FEE is of the opinion that providing transparency on the financial performance and position of an entity is the key objective of financial reporting. The role of financial reporting in financial stability is to provide the basis for, and in the current circumstances restore, market confidence. In this context, the accountancy profession has a contribution to make in helping to restore this confidence.
- (4) FEE has now issued four Policy Statements on the Accountancy Profession's Contribution to the Debate on the Crisis: the first statement presented the background information and analysis on the crisis, the second statement addressed matters of specific relevance for the statutory auditors during the financial crisis, the third paper contained views of specific relevance to SME and the fourth paper, recently issued, gave FEE's views on dynamic provisioning for financial instruments. These policy statements on the crisis can be downloaded from the FEE website www.fee.be and the fourth that is directly relevant for our response to Question 2 is attached.
- (5) The financial crisis is a global phenomenon that calls for a global reaction. Global financial markets require financial information prepared in accordance with global standards for reasons of competitiveness and comparability, as well as for capital raising purposes. FEE is strongly committed to high quality, principle-based financial reporting standards that are generally accepted around the globe and therefore fully supports the objective of creating a single set of global standards.



Questions

1. - From your perspective, where has general purpose financial reporting helped identify issues of concern during the financial crisis? Where has it not helped, or even possibly created unnecessary concerns? Please be as specific as possible in your answers.

- (6) FEE believes strongly that financial reporting based on IFRS, and notably fair value accounting for financial instruments, has revealed the economic reality of market participants' positions at an earlier stage than otherwise would have been the case under a more cost basis driven model. In our view, the requirement to account for certain financial instruments at fair value has not caused the financial crisis nor has it been a significant contributing factor. Nevertheless, practice has shown that fair value accounting is more difficult to apply in illiquid markets and preparers and auditors have had to use significant judgments to arrive at consistent valuations in difficult market circumstances. Preparers would benefit from additional guidance on fair value measurements when observable market prices are not available. In particular, additional guidance on the effect of illiquidity and risk premia could result in greater comparability of information across industry sectors and geographic boundaries.
- (7) Financial reporting under IFRS did show that financial institutions were highly geared. The introduction of IFRS 7 further improved risk disclosures on financial instruments. As 2007 was the first year that IFRS 7 was required to be applied and this gave greater scope to risk disclosure, it is expected that risk disclosures will further improve as more experience with the standard is being gained. The Financial Stability Forum disclosure requirements have also enhanced the risk disclosures.
- (8) The financial crisis has accelerated the discussion on the need to introduce anti-cyclical measures to the global system of financial regulation and to a certain extent also to financial reporting. Financial reporting has been blamed by some commentators for its pro-cyclical influence, thus aggravating the situation in markets that have become distressed or illiquid. We are of the opinion that the effects of the current market volatility are captured, but not caused by fair value accounting. Fair value provides a timely and relatively objective measure of existing value. Failure to report such values would leave investors and policy decision makers less aware or even unaware of credit and liquidity challenges. The accounting policies need to indicate carefully on which basis the fair values concerned have been determined.
- (9) One of the further implications of the crisis that can be expected soon to arrive, and in several countries and companies is already there, is the impairment of goodwill that again will seriously hit the profit and loss accounts. The increasing unemployment following restructurings and related provisions is also likely to impact the financial statements and have a further negative impact on the results.



- (10) One of the main questions is whether and to what extent to converge prudential/regulatory reporting and general purpose financial statements. Regulatory reporting and general purpose financial reporting have different objectives and these objectives might require the retention of the existing and establishment of new differences. Financial stability is primarily the area of responsibility of the regulators. The financial reporting role in financial stability is to provide and in the current circumstances restore market confidence by providing transparency and a true and fair view on the financial performance and position in individual reporting periods. This role is so important that it should not be biased by attempts to counter potential pro-cyclical effects, which may not necessarily reflect the inherent underlying economical cyclicity faced by the reporting entities.
- (11) FEE is of the opinion that transparency of the financial performance is the key objective of financial reporting and therefore regulatory adjustments should not automatically have financial reporting implications, since this approach does not distinguish periods of good and bad financial performance. Financial reporting should make the underlying economic reality including the economic cyclicity transparent. We support the IASB Conceptual Framework Approach that the objective of financial statements is to provide information that is useful to a wide range of users in making economic decisions, with priority given to the needs of providers of debt and equity capital. Primacy should not be given to the needs of governments and regulators since they typically have the power to obtain additional information directly from the company's management.
- (12) FEE welcomes the investigation of the Financial Crisis Advisory Group of the accounting and reporting matters related to the crisis based on the experience and developments so far. Only genuine improvements to financial reporting should be considered. Although a level playing field between IFRS and US GAAP is important, this also risks driving the global financial reporting towards the lowest common denominator. FEE supports the principle of seeking convergence, provided that this leads to the highest quality accounting solutions. Convergence may start with a careful analysis and selection of the best and most recent thinking under IFRS, US or any other national GAAPs where relevant. The development of the best accounting standards should however not be limited to the existing standards. Where necessary and relevant, the process should include new solutions and new thinking and the willingness of all involved to enter into new domains resulting in improved high quality accounting standards. We suggest therefore that convergence, in order to be successful, needs to go beyond existing accounting standards. New high quality standards on major issues such as financial instruments or pensions, developed jointly by the best resources from national/ regional standard setters and the IASB, that are generally acceptable to all stakeholders will in themselves ensure a level playing field for all countries that have adopted IFRS. Convergence of IFRS towards an existing particular national standard is then no longer needed to achieve that aim.
- (13) Another issue we would like to raise is auditability of the financial information and the accounting treatments to be applied. The reliability and verifiability of measurement is of concern when concepts such as "real economic value" came into the picture. Also Level 3 Measurement brings a high degree of subjectivity and requires substantial judgement of both the preparer and the auditor. Relevance is a significant qualitative characteristic of financial information but requires a balance with the reliability and verifiability characteristics.



2. – If prudential regulators were to require “through-the-cycle” or “dynamic” loan provisions that differ from the current IFRS or US GAAP requirements, how should general purpose financial statements best reflect the difference: (1) recognition in profit or loss (earnings); (2) recognition in other comprehensive income; (3) appropriate of equity outside of comprehensive income; (4) footnote disclosure only; (5) some other means; or (6) not at all? Please explain how your answer would promote transparency for investors and other resource providers.

- (14) FEE has issued on 23 March 2009 a policy statement on Dynamic Provisioning for Financial Instruments (please find a copy attached).
- (15) There is no clear and common understanding or shared general definition of what dynamic provisioning is. The mainstream understanding of expected loss provisioning is a provision for expected losses that have not yet been incurred, but have been priced into loan portfolios at inception. This expected loss provision is formed in periods where incurred losses are below the expected loss figures and is released in periods in which the incurred losses exceed the expected loss figures. Losses incurred in a particular period are generally deducted from the provision rather than being recognised immediately in profit or loss. Beyond that our understanding is that some commentators would welcome general “reserves” which might be established in “good times” and released when it is perceived that “bad times” are creating incurred losses. Both the expected losses and general reserves referred to above are contemplated within our understanding of the various definitions of dynamic provisions. The key input into this dynamic provisioning model is the expected loss and its allocation between reporting periods. Dynamic provisioning itself could also contribute to the pro-cyclical effect, when the provision is increased in “bad times” since even higher losses in “worse times” may be expected. Moreover, judgement is needed on when the downturn of the cycle is reached. A dynamic loss model is not a stress loss model that provides against “bad times”.
- (16) The main FEE views developed in this statement differentiate between short and long term view and are the following:

Short term view

- (17) If regulators allow entities to set up a dynamic provision for regulatory purposes (“economic cycle buffer”) as part of their short-term agenda then part of non-distributable reserves in equity in the general purpose financial statements could be allocated as a buffer with proper note disclosures whereby the amount is determined in the prudential returns (by the regulatory rules). FEE is not supportive of any form of dynamic provisioning in general purpose financial statements affecting net assets or performance measures of the reporting entity.
- (18) FEE also encourages the IASB to provide further educative guidance and explanation as to how to apply IAS 39 for incurred losses, since the incurred loss model is not equally applied by users in various territories. Such guidance would notably need to address the link to past events and losses inherently existing based on historical evidence adjusted for current circumstances.

Long term view

- (19) Any more fundamental change of general purpose financial reporting that would be considered by the IASB including potential move away from the current incurred loss model perhaps towards an expected loss model represented either by dynamic provisioning or a fair value model should be subject to in depth discussions and consultation and the full due process would need to be followed. The consistency with the currently discussed Conceptual Framework and other ongoing IASB projects, notably on financial instruments and fair value measurement (of which dynamic provisioning could be considered a sub-set), needs to be taken into account. In addition it is important that any changes to financial reporting should be made at a global level to IFRS to support comparability and maintain a level playing field.
- (20) Therefore, we are of the opinion that general purpose financial statements best reflect the difference between current IFRS (or US GAAP) requirements by the option (3): appropriation of equity outside of comprehensive income combined with proper note disclosure.

3. – Some FCAG members have indicated that they believe issues surrounding accounting for off-balance items such as securitisations and other structured entities have been far more contributory to the financial crisis than issues surrounding fair value (including mark-to-market) accounting. Do you agree, and how can we best improve IFRS and US GAAP in that area?

- (21) The IASB has published in December 2008, ED 10 on Consolidated Financial Statements with the objective of publishing a single IFRS on consolidation to replace the consolidation requirements in IAS 27 “Consolidated and Separate Financial Statements” and SIC 12 “Consolidation – Special Purpose Entities” in order to improve the definition of control and related application guidance so that a control model can be applied to all entities and to improve the disclosure requirements about consolidated and unconsolidated entities. Following the recommendations of the Financial Stability Forum, this consolidation project was accelerated.
- (22) However, we are unaware that any controlled companies and other structured entities are left off-balance-sheet under the existing requirements of IAS 27 and SIC 12. On the contrary, we are unsure at present whether the new model proposed in ED 10 will be an improvement compared to existing IFRS and meets the concerns expressed by the Financial Stability Forum that certain structured entities are inappropriately non-consolidated and left off balance sheet. Field testing and further analysis of user needs may be needed to ensure that the future standard will not result in unintended recognition and derecognition of assets and liabilities.
- (23) We appreciate the general direction of the new disclosures under ED 10 addressing two objectives: (i) providing better disclosure where significant judgment was used in determining whether to consolidate (or not consolidate) certain entities and (ii) providing more general disclosures related to the reporting entity's business risks taken through its involvement in non-consolidated entities.



4. – Most constituents agree that the current mixed attributes model for accounting and reporting of financial instruments under IFRS and US GAAP is overly complex and otherwise suboptimal. Some constituents (mainly investors) support reporting all financial instruments at fair value. Others support a refined mixed attributes model. Which approach do you support and why? If you support a refined mixed attributes model, what should that look like, and why, and do you view that as an interim step toward full fair value or as an end goal? Whichever approach you support, what improvements, if any, to fair value accounting do you believe are essential prerequisites to your end goal?

- (24) FEE supports a mixed attributes model for accounting and reporting of financial instruments under IFRS. We believe that adopting one measurement basis for all financial instruments will not inevitably reduce complexity. We are therefore of the opinion that the IASB should not expand the use of fair value in financial reporting. A mixed attributes measurement model would be more satisfactory at present and we therefore suggest that such a model should be subject to further research. Having a mixed-model for financial instruments should be favoured, as the accounting treatment should be driven to the extent possible by the consistently applied business model under which financial instruments are held by the entity. Since both banks and other preparers usually manage their financial instruments under different business models under which financial instruments are held and the underlying facts (for example keeping financial assets for a continuing use in order to benefit from the cash flows associated over time or managing financial assets and liabilities based on their fair value), the importance of the business model should be a key consideration for determining what measurement basis to apply for all different types of financial instruments (amortised cost or fair value).
- (25) There is significant complexity in the current reporting of financial instruments and there is a need to reduce this complexity recognising that by nature the subject of financial instruments is complicated, given the diversity of financial instruments and the related management methods ("business models").
- (26) FEE has contributed to EFRAG's comment letter on the IASB Discussion Paper "Reducing Complexity in Reporting Financial Instruments" as well as submitted a comment letter directly to the IASB on the Discussion Paper. We welcome the IASB/FASB announcement of last week to accelerate a revision of the financial instrument standard "as a matter of months rather than years".



5. – What criteria should accounting standard-setter consider in balancing the need for resolving an “emergency issue” on a timely basis and the need for active engagement from constituents through due process to help ensure high quality standards that are broadly accepted?

- (27) Although we recognise the need to resolve “emergency issues” on a timely basis, we would like to raise your attention to the recent experiences and the pitfalls of omitting the due process. We note that amendments to IAS 39 and IFRS 7 published by IASB on 13 October 2008 were a necessary step in the process of restoring a level playing field and creating confidence in financial markets. We accept that the omission of the due process was necessary given the critical circumstances of the financial crisis. However, any further amendments to IFRS – resulting from the crisis or otherwise should be given full consideration as to their implications and potential unintended consequences and be subject to an appropriate due process. This may be shortened if circumstances so require. The ED of proposed amendments to IFRS 7 *Financial Instruments: Disclosures “Investments in Debt Instruments”* is an example of an ED where we believe the due process has been wrongly shortened to 23 days. This proposal concerns an important subject that needs more fundamental discussion by stakeholders around the world than is at present the case in the ED.
- (28) We also refer to our response to point II of the Constitution Review in relation to fast track procedures. The Constitution could include a ‘fast track’ procedure to be used in rare circumstances, respecting an appropriate minimum due process, and the use of the ‘fast track’ procedure being subject to approval of the Trustees and SAC. This minimum due process should be described and should include a minimum consultation period. The IASB Due Process Handbook should include express provisions for the use of a shortened due process, including circumstances surrounding its application and approval of the use of the ‘fast track’ procedure in order to avoid any inappropriate use of this procedure. We suggest that those circumstances be limited to issues of wide concern amongst the community of IFRS stakeholders which can be solved by amendments with relatively less complexity.
- (29) Any fast track procedure should (i) still allow for stakeholder consultation as part of a minimum due process; (ii) include a minimum consultation method; (iii) be subject to approval of Trustees (or Supervisory Board) in each case; (iv) be only used for less complex emergency issues of wide concern amongst the community of stakeholders.

6. – Are there financial crisis-related issues that the IASB or the FASB have indicated they will be addressing that you believe are better addressed in combination with, or alternatively by, other organisations? If so, which issues and why, and which organisations?

- (30) We are strongly of the view that technical accounting standard setting should remain independent and not be politically influenced. Standard setting has become a greater interest to public policy makers and regulators as a result of wider international adoption of IFRS and the financial and economic crises. The creation of the Monitoring Board provides a mechanism to achieve appropriate accountability.



- (31) FEE is of the opinion that it is the IASB's role to develop IFRS so as to help ensure that general purpose financial reports are as effective as possible in meeting their objectives in a way that minimises costs for preparers and users. It should not involve itself in other issues. As far as we are aware, the IASB is not addressing any issues that fall outside the scope that we have just described. We would furthermore be strongly against encouraging the IASB to address issues that fall outside this scope, such as issues on financial stability or prudential regulation that go beyond what is necessary to meet the objectives of general purpose financial reporting.
- (32) FEE believes that accounting standards should continue to focus on the primary objective of meeting the needs of capital market users. Macro-economic objectives, including financial stability should be achieved by other means such as macro-economic policy and regulatory actions as described above. Nevertheless, the IASB needs to consider the impact its standards may have on the stability of financial markets. Therefore, continued cooperation between the IASB and global regulatory networks such as IOSCO and FSF is important. We support the IASB in the efforts to maintain and enhance these relationships by participating actively in the FSF and IOSCO accounting related activities.

7. – Is there any other input that you would like to convey to the FCAG?

- (33) There is no other input that we would like to convey at this stage.

For further information on this letter, please contact Ms. Saskia Slomp from the FEE Secretariat.

Yours sincerely,

A handwritten signature in black ink, appearing to be 'Hans van Damme', written over a circular stamp or seal.

Hans van Damme
President

Encl.

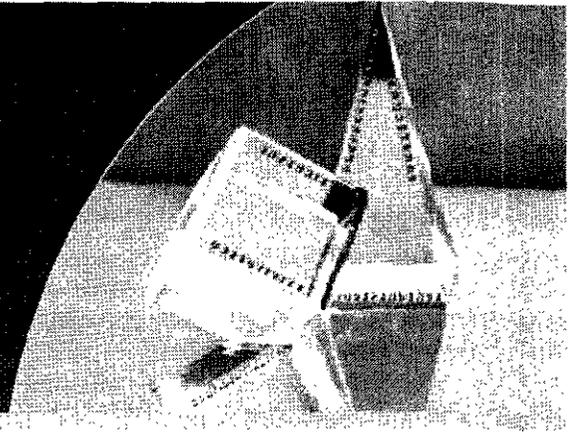


Federation of European Accountants
Fédération des Experts comptables Européens

Policy Statement

Standing for trust and integrity

March 2009



The Accountancy Profession's Contribution to the Debate on the Crisis (IV)

Dynamic Provisioning for Financial Instruments

FEE, the Federation of European Accountants – Fédération des Experts comptables Européens, wishes to contribute its views and experience to the debate on the current crisis, the ways to mitigate its effects and to speedup recovery. This paper presents the views of FEE on dynamic provisioning. Three other papers have been issued in December 2008, one presenting background information and analysis on the crisis (I), a second paper on the matters of specific relevance for statutory auditors during the financial crisis (II), and a third paper containing views of specific relevance to SMEs (III).

About FEE

FEE represents 43 professional institutes of accountants and auditors from 32 European countries, including all 27 EU Member States. It has a combined membership of more than 500.000 professional accountants. In representing the profession, FEE recognises the public interest. Professional accountants work in different capacities in public practice, business, and public sector, based on the practical experience gained in this daily involvement in all aspects of the economy and the set of values underpinning the profession's practice, FEE believes it has a contribution to make in the current discussions.

Background

The financial crisis has accelerated the discussion on the need to introduce anti-cyclical measures to the global system of financial regulation and to a certain extent also to financial reporting. Such discussion inevitably opened the issue whether and to what extent to converge regulatory/prudential financial returns and general purpose financial statements. One of the related issues discussed is the level at which both types of reporting have contributed to pro-cyclicality. Also the de Larosière report as issued at the end of February 2009, refers to pro-cyclicality in recommendation 4: "accounting standards should not bias business models, promote pro-cyclical behaviour or discourage long-term investment".

In the current discussions on reporting implications of the financial crisis dynamic provisioning is often mentioned as one of the possible "solutions" to avoid pro-cyclicality not only in the prudential returns but also in the general purpose financial

statements. G20 has a work stream on dynamic provisioning in preparation for its April 2009 meeting.

Dynamic provisioning

There is no clear and common understanding or shared general definition of what dynamic provisioning is. Various approaches are using loan specific, entity specific, country specific loss expectations, in most cases covering the whole period to maturity of the loan. Depending on the country, history and culture different views are held about what is a dynamic provision and whether such a provision is compatible with IAS 39. There are also differing views on when an "incurred loss" is incurred, opening the issue whether the current model is consistently understood and applied.

The underlying question is whether general purpose financial reporting should embrace provisions for future losses on existing loans/receivables which arise from events or circumstances which have not yet arisen but which are expected to arise over

the term of the loan, i.e. an expected loss model. Should such an expected loss model be considered rather than continue with a conservatively applied incurred loss model as currently applied?

The mainstream understanding of expected loss provisioning is a provision for expected losses that have not yet been incurred, but have been priced into loan portfolios at inception. This expected loss provision is formed in periods where incurred losses are below the expected loss figures and is released in periods in which the incurred losses exceed the expected loss figures. Beyond that our understanding is that some commentators would welcome general "reserves" which might be established in "good times" and released when it is perceived that "bad times" are creating incurred losses. Both the expected losses and general reserves referred to above are contemplated within our understanding of the various definitions of dynamic provisions. The key input into this dynamic provisioning model is the expected loss and its allocation between reporting periods.

FEE position

Regulatory reporting and general purpose financial reporting have different objectives. Financial stability is primarily the responsibility of the regulators. The financial reporting role in financial stability is to provide and in the current circumstances restore market confidence by providing transparency and a true and fair view on financial performance and position in individual reporting periods. This role is so important that it should not be biased by attempts to counter potential pro-cyclical effects, which do not reflect the inherent underlying economical cyclicity faced by the reporting entity. Dynamic provisioning itself could also contribute to the pro-cyclical effect, when the provision is increased in "bad times" since even higher losses in "worse times" may be expected.

Regulators are only one of the stakeholders of financial statements and their main objective is to ensure the long-term stability of the system on behalf of depositors, which results in the incentives to keep the necessary capital within the financial institutions whereas shareholders and investors require a more performance oriented view. Including dynamic provisions – whereby the provisions are recognised as liabilities through a profit and loss charge – and which have a prudential objective, in general purpose financial reporting standards will not be helpful to investors and other stakeholders to understand the results of the period concerned or assess the quality of the earnings. Therefore, what is appropriate from a regulatory point of view is not necessarily the best presentation from a general purpose financial reporting point of view.

Good cooperation between the regulators and accounting standard setters is important and we welcome their increased cooperation in this respect.

FEE is of the opinion that transparency of the financial performance is the key objective of financial reporting and therefore regulatory adjustments should not automatically have financial reporting implications, since this approach does not distinguish periods of good and bad financial performance. Financial reporting should make the underlying economic reality including the economic cyclicity transparent. We support the IASB Conceptual Framework Approach that the objective of financial statements is to provide information that is useful to a wide range of users in making economic decisions, with priority given to the needs of providers of debt and equity capital. Primacy should not be given to the needs of governments and regulators since they typically have the power to obtain additional information directly from the company's management.

What preferences exist in practice for international accounting standard setters like?

Short term view

If regulators allow entities to set up a dynamic provision for regulatory purposes ("economic cycle buffer") as part of their short-term agenda based on the de Larosière report then part of non-distributable reserves in equity in the general purpose financial statements could be allocated as a buffer with proper note disclosures whereby the amount is determined in the prudential returns (by the regulatory rules). FEE is not supportive of any form of dynamic provisioning in general purpose financial statements affecting net assets or performance measures of the reporting entity.

FEE also encourages the IASB to provide further educative guidance and explanation as to how to conservatively apply IAS 39 for incurred losses since the incurred loss model is not equally applied by users in various territories. Such

guidance would notably need to address the link to past events and losses inherently existing based on historical evidence adjusted for current circumstances.

Long term view

Any more fundamental change of general purpose financial reporting that would be considered by the IASB including potential move away from the current incurred loss model perhaps towards an expected loss model represented either by dynamic provisioning or a fair value model should be subject to in depth discussions and consultation and the full due process would need to be followed. The consistency with the currently discussed Conceptual Framework and other ongoing IASB projects, notably on financial instruments and fair value measurement (of which dynamic provisioning could be considered a sub-set, needs to be taken into account. In addition it is important that any changes to financial reporting should be made at a global level to IFRS to support comparability and maintain a level playing field. ²⁵