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For the attention of Mr Adam Van Eperen Financial Crisis Advisory Group Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116



2 April 2009

LETTER OF COMMENT NO. 34

Dear Sirs.

Financial Crisis Advisory Group Seeking Input from Constituents

We are pleased to have the opportunity to respond to questions raised by the Financial Crisis Advisory Group (FCAG). We welcome the Group's efforts in seeking input from constituents. We remain highly supportive of achieving the goal of a single set of high quality accounting standards that are accepted and applied across the world's capital markets. The work of the FCAG is critical to assisting the IASB and FASB in achieving that goal in accounting for financial instruments.

Following consultation with members of the PricewaterhouseCoopers network of firms, this response summarises the views of member firms who commented on this discussion document. "PricewaterhouseCoopers" refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

The unprecedented financial crisis has led a number of affected parties to consider the need for improvements in different areas. Financial accounting and reporting is one area that warrants such consideration. While many aspects of financial reporting met the intended objectives despite the volatile environment, there is an urgent need to examine the issues that have arisen, particularly in the context of fair value accounting. This offers an opportunity to propose improvements that could lead to greater simplicity, transparency and understanding.

Moreover we note that the financial crisis has had a global impact and has affected financial institutions around the world. This has highlighted the need for there to be a single set of high quality accounting standards that can be applied globally. We urge the Boards to work together on those areas where there are currently significant differences in approach in accounting for financial instruments, including the related areas of consolidation and derecognition.

The financial crisis has also helped to illustrate the dichotomy between the roles of financial reporting (to investors and other users of financial reports in the capital markets) and prudential reporting to regulators and other official bodies. We support appropriate moves to improve prudential regulation so as to respond to recent events, but we also believe that regulatory requirements should not be a driver of accounting standards and should not change the focus of financial reporting.

We have set out our responses to each of the specific questions in the attached Annex.

If you have any questions in relation to this letter please do not hesitate to contact Richard Keys, PwC Global Chief Accountant (+44 20 7802 4555), Russ Mallett (+1 973 236 7115) or Pauline Wallace (+44 20 7804 1283).

Yours faithfully

PricewaterhouseCoopers LLP

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ANNEX

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.

The objective of general purpose financial statements is to provide information about the financial position, performance, and changes in financial position of an entity that is useful to a wide range of users in making economic decisions, with primacy given to the needs of providers of debt and equity capital.

We believe that financial reporting met its objectives during the financial crisis and, in the following areas, helped identify issues of concern.

Fair value

The early stages of the financial crisis were marked by a rapid increase in defaults in the subprime mortgage market which in turn led to rapidly declining fair values on associated structured financial instruments. The fair value model caused increased focus on the deteriorating economics and may have revealed the decline in assets values and the associated economic implications to both investors and policy makers more quickly. Fair value provides transparency to users of financial statements about the effects of current market conditions. If fair values were not reported, the result would be that management would know the real prices at which transactions were concluded, as would counterparties to transactions, but investors would not.

Disclosure and transparency

During the financial crisis, valuation methodologies, exposure to structured finance activities and the level of disclosure and understanding in the market of a bank's financial risk management strategies have all come under intense focus. IFRS 7 (which for most companies was applied for the first time in their 2007 financial statements) as well as SFAS 157 and the "Dear CFO" letters issued by the SEC improved the quality of disclosures most impacted by the turmoil during this period. For example there was an overall increase in disclosure on the use of fair value as banks discussed valuation techniques using significant unobservable parameters. There was also an increase in the disclosure of credit and liquidity risks and the impact of changes in these variables on valuations. However as noted by the Financial Stability Forum (FSF) and the Group of Twenty (G20), these are still areas where enhancements can be made to provide even greater transparency and understanding.

Contrast between financial and prudential reporting

The financial crisis has helped to illustrate and stimulate a debate on the different roles of financial reporting to investors and other users of financial reports in the capital markets and prudential reporting to regulators and other official bodies. It has acted as a catalyst for discussion about the objectives of financial reporting and its intended audience, and in turn the objectives of accounting standard-setting. We support appropriate moves to improve prudential regulation so as to respond to recent events, but we also believe that regulatory requirements should not be a driver of accounting standards and should not change the focus of financial reporting.

However we believe that the financial crisis has also exposed the need to explore other areas of financial reporting where the unprecedented economic environment presented challenges which had not previously been identified. We therefore welcome the Boards' joint agreement to develop a new accounting standard for financial instruments. In particular, we encourage them to address the following issues as part of that process as these represent particular challenges identified as a result of the crisis.

Illiquid Markets

Determining fair value under current market conditions is extremely challenging, especially for instruments that are not actively traded. In addition liquidity pressures and other market factors have resulted in significant and unusual risk premiums for some instruments. This has sparked the debate over whether the accounting and reporting of fair value can be improved when markets become illiquid. We encourage the Boards to address this when developing the new proposals for accounting for financial instruments.

Impairment of financial assets

Both US GAAP and IFRS have several impairment models for financial assets. The models have different recognition triggers, different measurements of impairment losses, and different abilities to reverse previously recognised impairments. In some cases, the recognition triggers are inconsistent with the measurement approach used. In addition, not only are there several different models within IFRS and US GAAP, there are also significant differences between IFRS and US GAAP – starting with the types of instruments to which the different impairment models in IFRS and US GAAP are applied.

For example, the impairment models under IFRS for debt at amortised cost and available for sale (AFS) debt instruments are inconsistent with each other: while both recognise losses only when there is a credit-related event, the impairment loss is measured differently. Impairment of debt instruments held at amortised cost is solely related to the impact of credit loss events on the contractual cash flows in the instrument. This is consistent with the incurred loss measurement approach. Impairment of AFS debt instruments, however, reflects the entire change in fair value including the impact of market factors (i.e. changes in interest rate and credit spread, including liquidity factors) in addition to credit loss events. This is inconsistent with the IFRS requirement for a credit-related event to trigger initial recognition of impairment. Consequently it creates application and interpretation difficulties in determining the extent to which recoverability of underlying cash flows has been impaired, and in deciding when subsequent impairment or reversals of impairment are recognised.

In light of this, we would encourage the Boards to develop a single impairment model that applies to all financial assets. The benefits of a single model include global accounting consistency, less complexity, and more transparency around financial reporting to investors.

Liabilities measured at fair value through profit or loss

One of the observable effects of the current crisis has been that banks have generated significant gains from fair valuing their own liabilities as credit spreads widened. While some may believe that this appropriately reflects the current economic environment, others would disagree with the notion that an entity should recognise income as a result of deteriorating credit quality. In particular, it has been difficult to explain to users of financial statements why income is recognised when a company's creditworthiness deteriorates. As conditions improve, these "gains" will be reversed resulting in further losses for banks despite the improving economic conditions. Critics argue such accounting could delay the recovery of the economy even longer. This debate needs to be addressed in the forthcoming exposure draft on fair value measurements from the IASB. In particular this should consider alternative measurement attributes for non-derivative financial liabilities, including whether a settlement model may be more relevant than a exit price model. We welcome the opportunity to comment on this critical matter.

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) appropriation 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.

The debate should focus on the objective of general purpose financial statements. Hence, any reflection of prudential 'through the cycle' reserves in the financial statements should be assessed to determine whether it meets the objective of general purpose financial reporting. Other objectives (such as financial stability or prudential objectives) should also be considered in evaluating reporting requirements to the extent that they do not conflict with sound reporting to investors.

We would support fully transparent disclosure in the notes to the financial statements of details of additional amounts of reserves required for regulatory purposes, including the basis on which those reserves have been calculated. This is consistent with the disclosure requirements in IAS 1 to provide information that enables users to evaluate the entity's objectives, policies and processes for managing capital.

Whilst recognising the contribution that "through the cycle" reserving may make to financial stability, we believe there are a number of disadvantages to recognising such reserves in either profit or loss or other comprehensive income which we summarise below:

- Typically such a reserve is calculated using a formula that reflects loan growth, the rate of
 provisioning and historical loss experience but there is no universally agreed formula that
 can be consistently applied. There is therefore a risk that its introduction would impair
 transparency and comparability between banks and might disguise attempts at earnings
 management.
- If, on the other hand, a more rigid formula is established by a country's regulator for application to all banks under its jurisdiction, the performance of individual banks and the quality of their loan books may not be readily determinable and there is unlikely to be a robust basis for comparison between banks regulated by different regulators.
- Since average loan maturities have historically been shorter than economic cycles, it is
 probable that reserves established in the good times will be used to meet losses on loans
 that have not yet been made, thus distorting period on period comparisons and
 accelerating the recognition of losses on assets that have not yet been originated.
- "Through the cycle" reserving may generate false confidence in the banking sector as the
 model assumes an average downturn. If the downturn is more severe than anticipated, the
 level of provisions established at the peak of the economic cycle will not be sufficient to
 absorb actual losses leading to unexpected loss recognition.
- "Through the cycle" reserving reports "excessive" earnings in times of stress, which
 appears inconsistent with actual economic performance at that time.
- Loan loss provisioning is not the only area of difference between regulatory capital and accounting equity in some jurisdictions. Consequently an additional reconciliation would be required between the two to provide full transparency around the regulatory regime under which the bank is operating.

In addition, we note that the Boards are considering a revision to accounting standards to require an expected loss method based on a point in time model – possibly by measuring loans based on expected future cash flows (including credit losses) discounted using a current market rate and thus reflecting changes in expectations as they occur. As part of the development of a new accounting standard on financial instruments, we would encourage the Boards to investigate such an expected loss model further.

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?

The origins of the crisis did not result from financial reporting or accounting issues. Rather, the crisis was caused by many factors including inappropriate lending and securitisation activities; the effects of deregulation; creation of investment vehicles that investors did not understand; poor risk management investment decisions; lack of transparency; and ultimately a breakdown in "confidence" or "trust" in the system.

The financial crisis highlighted that the real issue around off-balance sheet entities was that companies and investors often did not fully understand or appreciate the potential risk exposures arising from their investments in these entities. In the US, fewer structured entities were on balance sheet, however there were significant financial statement footnote disclosure requirements. Under IFRS, the majority of securitisation vehicles were on balance sheet and the issues were more around the extent of disclosure than the accounting treatment.

As a result, now is a good opportunity for the FASB and IASB to work together on their consolidation and derecognition projects to develop a consistent model that will improve transparency of the risks associated with off balance sheet entities. We do not however underestimate the challenge involved in achieving consensus views of stakeholders on these important topics, and we would therefore urge the Boards to ensure that there is appropriate time for consultation with interested parties.

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?

As noted in our September 2008 response to the *Discussion Paper on Reducing Complexity in Reporting Financial Instruments*, we support a mixed measurement model for financial instruments. Whilst we recognise that some investors have called for a move towards the use of fair value for all financial instruments, other investors have a different perspective. The current financial crisis has changed the economic environment and has challenged many of the underlying assumptions in IAS 39, including the use of fair values in illiquid markets.

In our opinion, a company's business model and the intent behind entering into financial instruments should be key drivers in reporting the performance of financial instruments in the income statement. That intention is more relevant than the legal form of the instrument itself. There are instances where the application of fair value accounting raises legitimate questions about whether reported earnings reflect hypothetical losses rather than real economic performance. For example, if an entity has the ability to hold a financial asset and is not forced to sell in a distressed market, it will not incur substantial immediate losses. However, a requirement to reflect the fair value movement through the income statement leads to the recognition of a hypothetical loss.

Consequently our view is that changes in the fair value of financial instruments which are being actively traded or entered into for short-term or speculative gain from movements in price should be recognised in the income statement. By contrast, the change in underlying fair value should not be recognised in the income statement for a non-trading strategy as this does not reflect the economic exposure created by such a strategy.

Both equity and debt investors will consider a company's strategy and business model when determining whether to invest. Hence, if the application of a business model concept to accounting for financial instruments can effectively present the economic use of those financial instruments as it relates to the organisation's strategy, then it is likely to represent relevant reporting in the eyes of the user.

5. What criteria should accounting standard-setters 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?

As noted in our response to the IASCF Trustees' discussion paper on Part 2 of the Constitutional Review, we believe that there should be the capability under the constitution to consult quickly on matters that are addressed by the Board in response to emergency situations. It is not helpful to have instances where the Trustees have to announce that they are 'suspending' due process, as this serves to undermine market confidence. However, an accelerated due process should still provide the opportunity for stakeholders to comment on proposed changes, even if the comment deadlines are significantly shortened. We believe such a process is needed and relevant from both a US and International perspective.

In setting out any proposals for the due process to be followed in such circumstances, it will be important to provide a clear definition of what an 'emergency issue' is – for example, something that a significant number of constituents, especially users, are calling for. It might also be appropriate to provide in such cases for a subsequent review to be performed within a specified period, to assess whether the 'fast-tracked' amendment is working as intended.

In addition, the Boards should recognise the practical difficulties associated with retrospective application of urgent changes for measurement purposes, particularly in relation to generating comparative data.

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?

Where any changes are proposed to IFRS and US GAAP, we encourage the Boards to consult as widely as possible and in particular with user groups.

As noted above in our response to Question 2, the objective of general purpose financial reporting and accounting standard-setting should be to support the efficient and effective operation of the capital markets. Accounting standard setters should be responsible for everything that is within the ambit of financial reporting. However we recognise that there are issues such as 'through the cycle' reserves that are important for financial stability purposes. In such cases it will be important for the Boards to communicate and work closely with other organisations. We therefore encourage continuation of the dialogue between regulators, standard setters and others in enhancing capital requirements. This should be considered in light of the work that the Financial Stability Forum, in conjunction with others, has been conducting in examining pro-cyclicality.

7. Is there any other input that you'd like to convey to the FCAG?

The financial crisis has revealed resource constraints at the IASB. Our view is that the Board's current work programme, taken as a whole, has too many 'live' projects. At a time when the IASB has, quite properly, been asked to address issues arising from the financial crisis, items that are not responding to an urgent need from the market should be dropped or deferred. There should be sufficient flexibility to change the agenda depending on the prevailing circumstances.

The financial crisis has also illustrated the extent of detailed differences between IFRS and US GAAP and the risk of interested parties arbitraging between different frameworks and claiming unequal treatment (for example, the October 2008 reclassification amendment published by the IASB was a result of this). We strongly agree with the G20 recommendation of last November that the IASB and FASB need to work together intensively towards the objective of creating a single global set of high-quality standards – and particularly in the area of financial instruments.

There is a risk that any response to the challenges posed by current economic circumstances could add to the complexity of financial reporting. For example, we note that changes in accounting standards over the years have tended to add new disclosure requirements but very few have ever been taken away. We encourage the Boards to identify and remove those disclosure requirements that contribute large volume without much value by creating a more principles-based approach to disclosures with a greater focus on the reporting entity's risk.

Finally, we would encourage the Boards to consider the status of their respective non-authoritative guidance around financial instruments. In particular, the Boards should consider whether there is a need for them to issue more authoritative guidance to help preparers address the practical issues of valuing complex financial instruments in illiquid markets.