



LETTER OF COMMENT NO.

45



THE INSTITUTE
OF CHARTERED
ACCOUNTANTS

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Your ref:

Adam Van Eperen
Financial Crisis Advisory Group
c/o International Accounting Standards Board
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By email: ajvaneperen@fasb.org

Dear Adam

FINANCIAL CRISIS ADVISORY GROUP

The Institute of Chartered Accountants in England and Wales (the ICAEW) welcomes the opportunity to respond to the Financial Crisis Advisory Group's request for comments on certain accounting and reporting matters related to the financial crisis.

Please let me know if you require any further information regarding the points raised in the attached response.

Yours sincerely

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THE INSTITUTE
OF CHARTERED
ACCOUNTANTS

ICAEW Representation

ICAEW REP 42/09

THE FINANCIAL CRISIS: ACCOUNTING AND REPORTING

Memorandum of comment submitted in March 2009 by The Institute of Chartered Accountants in England and Wales in response to the Financial Crisis Advisory Group's request for comments concerning certain accounting and reporting matters related to the financial crisis, published on 10 March 2009

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales welcomes the opportunity to comment on the Financial Crisis Advisory Group's (FCAG's) request for written responses to seven questions concerning accounting and reporting matters related to the financial crisis, published on 10 March 2009.

WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 132,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 750,000 members worldwide.
3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.
4. Our members occupy a wide range of roles throughout the economy. This response was developed by the Financial Reporting Committee of the Institute, which includes preparers, analysts, standard-setters and academics as well as senior members of accounting firms.

SPECIFIC QUESTIONS

Question 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.

5. We believe there is a need for further evidence-based study on these questions. This is particularly important in order to avoid knee-jerk reactions that purport to solve problems but in fact do not and may even cause greater problems in the future. Signs of financial problems within an entity are often apparent in general purpose financial reports but may only be identified using hindsight. This highlights the importance of disclosure being understandable and sufficient but not so excessive that key information is hidden.
6. Our tentative answers on this point reflect our members' experiences and perceptions, and the evidence available from the report of the US Securities and Exchange Commission (SEC) on mark-to-market accounting, which tackles what is probably the most controversial point at issue. We also refer to the recently published *Turner Review: A Regulatory Response to the Global Banking Crisis* by the Chairman of the UK Financial Services Authority (FSA), although we note that the evidence-base for some of the conclusions of this report is unclear.

7. In the UK, a number of banks have had to be rescued by the government. Financial reporting has sometimes helped to give warning of problems at these institutions, but we have not seen any evidence that it was a cause of their problems. Rather, the causes of failure are usually seen as:
- significant holdings of financial assets that depend directly or indirectly on lending against property assets (either in the UK or abroad, especially in the US) and whose value is seen to be impaired; and
 - actual or forecast difficulties in meeting financing needs as liquidity dried up in the market. This is usually the immediate cause of failure and exacerbated the banks' mismatch between long-term assets and short-term debt. But it is arguable that the market's unwillingness to provide funds to meet financing needs reflects its concerns about the value of institutions' assets and therefore about the recoverability of funding provided to the institutions in question.
8. In the current crisis, the use of fair value for certain financial instruments has been particularly controversial. We believe that, generally speaking, the use of fair values for these items has actually been beneficial, helping to bring problems to light earlier and allowing them to be dealt with expeditiously. However, we would point out that, in some cases, events leading to an institution's failure were so rapid that any periodic (eg, quarterly) reporting of fair values could have had no effect.
9. The SEC's *Study on Mark-to-Market Accounting*, published at the end of 2008, is the most substantial study to date of the issues addressed by these questions. Its findings are broadly consistent with our own analysis.
10. On the question of whether the existing fair value requirements contributed to the financial crisis by helping to cause bank failures, the SEC report concludes:
- 'bank failures in the US appeared to be the result of growing probable credit losses, concerns about asset quality, and, in certain cases, eroding lender and investor confidence. For the failed banks that did recognize sizable fair value losses, it does not appear that the reporting of these losses was the reason the bank failed.'
11. On the question of whether the existing fair value requirements contribute to the quality of financial reporting information, it notes:
- 'investors generally support measurements at fair value as providing the most transparent financial reporting of an investment, thereby facilitating better investment decision-making and more efficient capital allocation amongst firms.'
- However, it also notes that 'while investors generally expressed support for existing fair value requirements, many also indicated the need for improvements to the application of existing standards'.

12. By contrast, the *Turner Review* claims that:

'While it is difficult to quantify the effect, it is a reasonable judgement that the application of fair value/mark-to-market accounting in trading books, played a significant role in driving the unsustainable upswing in credit security values in the years running up to 2007, and has exacerbated the downswing.'

13. In spite of this, the FSA report endorses the current use of fair value in corporate reporting, and even comments:

'And the evidence of the crisis suggests that the institutions which most rigorously applied mark-to-market approaches, identifying rapidly the impact of falling liquidity and falling prices, performed best since they exited problem areas faster and at lower eventual cost.'

As we have already noted, it is not clear what evidence underlies the report's conclusions.

14. There is also an argument that the current approach to calculating impairments to financial instruments measured on a historical cost basis (the 'incurred loss' model) is to some extent pro-cyclical. While we do not have any evidence on this point, we believe that it would be appropriate to review the incurred loss model and the principal alternative to it (the 'expected loss' model) and to consider which basis will provide investors with the most useful information.
15. As far as we have been able to ascertain, there is at present no good evidence that financial reporting either caused the current crisis or made it significantly worse. But we recognise that there is none the less an argument that the use of fair values and perhaps the incurred loss impairment model are pro-cyclical. It is possible to some extent that this is the case, but it is a question that calls for thorough research before any changes are considered. It is equally arguable, as we stated above and as the *Turner Review* suggests, that the use of fair value in particular has helped to bring problems to light earlier, allowing them to be dealt with expeditiously. To this extent, the use of fair values may actually be counter-cyclical. It is quite possible, therefore, that in certain respects fair value accounting is pro-cyclical while in others it is counter-cyclical. So far as it is pro-cyclical, its effects need to be considered in the context of the broader benefits of transparency and counter-cyclical capital adequacy requirements.

Question 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?

16. We assume, as the question does, that any intervention of this sort by regulators would leave it open to financial reporting standard-setters to determine how, if at all, any relevant 'provisions' would be reported in the

financial statements. Although there are interrelationships between general purpose financial statements for investor decision-making and prudential regulation, and investors may be interested in both, it is important that the needs of prudential regulation do not muddy the water for investors by changing key metrics in relation to net income and net assets. Generally, if there is a conflict between the two, the needs of investors for general purpose financial statements should prevail because prudential regulators, unlike investors, have the power to require other information from entities on demand.

17. It is worth noting that the *Turner Review* took an alternative approach to dynamic provisioning (which would relate only to the loan book) by suggesting an Economic Cycle Reserve (or possibly an Economic Cycle Provision), which would act as an overall reserve buffer for an institution, determined according to an assessment of the position in the economic cycle. In other words, this would 'set aside profit in good years to anticipate losses likely to arise in future'.
18. Neither of these 'provisions' would meet the definition of a liability under IFRS and so we also assume that they should be treated as reserve movements, and thus would be transfers from retained earnings to a separate reserve (and vice versa to the extent that the reserves are released). As such, it would not be appropriate for movements to be recognised in either the income statement or other comprehensive income. Thus we believe that any such reserves should be recognised as a separate category of reserve in the balance sheet and for movements in this reserve to be disclosed in the statement of changes in equity, with additional details in the notes to the financial statements.
19. In relation to the *Turner Review* proposal for an 'Economic Cycle Reserve' for banks, from the way in which this transfer to a separate ECR reserve is described, it is not entirely clear whether it should be regarded as a charge against profit or an appropriation of profit. The report seems to envisage that the accounting treatment would be settled jointly by banking regulators and financial reporting standard-setters. The FSA consultation paper accompanying the *Turner Review* outlines both alternatives, ie, treating the ECR as a provision, with movements taken against profit, or as a reserve movement, which would not impact the income statement. Lord Turner seems to favour the former treatment, so the movement would preferably appear in the income statement, with earnings per share calculated both before and after the 'reserve movement' for the year. This appears to be in the belief that putting the movement against profits will affect remuneration policies based on earnings, amongst other things. We have doubts that this would be the effect in practice, as entities can and do adjust earnings numbers for remuneration purposes as they see fit. Regulators would therefore need to require the reserve to be taken into account in remuneration decisions, but this could be done without affecting the external reporting. We will be responding to the *Turner Review* in due course in a submission to the FSA, but these views are likely to be reflected in that response.
20. An approach we might support is to treat the reserve as an appropriation of profit, but show profit and EPS before and after the movement in a memorandum below the GAAP statement of comprehensive income. Even this is far from ideal, however, because earnings and EPS figures are there for investors, not as some kind of moderator of corporate behaviour as

desired by a regulator, so the validity of producing them in external financial reports is dubious. And in any case generally we do not advocate mandatory non-GAAP measures in financial statements for a variety of reasons (and some regulators, such as the SEC, actively discourage them).

21. Another issue relates to distributable reserves, which we realise is not usually an issue for the IASB or FASB. Many, including Lord Turner in his *Review*, also tie this type of requirement to the issue of distributable reserves (as well as remuneration), so that the transfer from retained earnings to a separate Economic Cycle Reserve (ECR) would represent a transfer from a distributable to a non-distributable reserve and hence distributable profits would be reduced. The driver here seems to be a belief that banks have been over-distributing to shareholders and have not retained sufficient reserves beyond their prudential capital requirements. However, this is a difficult legal and technical issue and one which will have different effects in different jurisdictions, depending on the relevant legal rules.
22. In the UK, for example, distributable reserves are not assessed on a group basis, but rather on a legal entity basis, by reference to the individual accounts of the entity. And even within a legal entity, the accounting retained earnings will not always (or even usually) represent distributable reserves because separate rules on distributable profits will require the exclusion of, amongst other things, unrealised gains in relation to illiquid assets. In order to affect distributable reserves, the requirement would need to be for the parent entity to set aside the ECR from its distributable reserves in its individual entity accounts, which would then feed through to the group accounts (as opposed to just being a consolidation adjustment in the group accounts). However, other regimes may have different rules, for example distributions may be assessed by reference to the whole group, or distributions may be made on a solvency basis.
23. Any proposal to tie the ECR to distributable reserves is thus, in our view, fundamentally misguided in so far as it seeks to influence dividend policy. It would not restrict the ability of a company to pay dividends in a solvency-based regime such as the US. Even if legislation specified the reserve to be non-distributable, this would be meaningless if distributions could be made without reference to amounts stated in accounts. Moreover, even in a jurisdiction such as the UK, companies whose reserves are depleted, whether by an additional regulatory non-distributable reserving or by any other means, can often create distributable reserves in a number of ways. Provided a bank had not been overdistributing or distributing near its limit in the past, it may well in practice be able to replace the distributable reserves lost to the ECR at some point and thus maintain or reintroduce its previous distribution and buy back policy.
24. A better approach might be for the ECR simply to be part of regulatory capital which would have to be preserved, if necessary through raising of additional capital, for the bank to remain authorised to do business. However, in that case, the reserve is really nothing to do with financial reporting and is simply a buffer agreed with regulators for regulatory purposes. If it appears in the accounts at all, it would simply be as part of an explanation of the bank's capital structure and regulatory requirements.

Question 3

Some FCAG members have indicated that they believe issues surrounding accounting for off-balance sheet 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?

25. We are unaware of the rationale for suggesting that the accounting for off-balance sheet items has contributed to the financial crisis. In our recent response to the IASB's ED 10 on consolidation, we state our belief that the main problems in relation to off balance sheet SPVs have arisen in the US, where US GAAP is different (and in our view, less effective) than IFRS. Our view is that IAS 27 and SIC-12 have been and are operating well, and only require some minor adjustments that would be helpful in particular situations. It is not at all clear that anything that has not been consolidated under IFRS should have been (and vice versa) in terms of delivering better information to investors. We also suggest that disclosure in relation to off balance sheet items needs to be focused and proportionate, to give clarity for investors. In this respect, ED 10 is excessive, requiring every twig and branch to be shown, so investors would be unable to see the wood for the trees.
26. This may look very different from a prudential regulation perspective, where risks that did not require items to be consolidated were nevertheless such that a prudential regulator would have wanted them brought into consideration in the context of prudential regulation. In that case, the regulator can demand separate information without changing the approach in the general purpose financial statements if these serve investors well in terms of transparency. As far as we are aware, however, at least in relation to unconsolidated SPVs, it is not suggested that regulators did not have sufficient information. For financial reporting, rather than concentrating on this from a consolidation point of view, it would perhaps be more useful to consider whether the disclosure around risks could be improved, particularly in relation to risks arising from things that are, rightly, not on balance sheet, ie, commitments and contingent liabilities. There are new EU rules just coming into force on disclosure relating to off balance sheet arrangements requirements, but these are not adequately defined in the legislation, so accounting standards could usefully fill the void by attempting a more helpful approach to such disclosures.

Question 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?

27. We disagree with the comment that the current mixed attributes model for financial instruments is 'overly complex and otherwise suboptimal'. We

commented last year on the IASB's discussion paper, *Reducing Complexity in Reporting Financial Instruments*. Our views are set out in detail there, but broadly we do not see that major changes are needed to the current split between fair value and historical cost in accounting for financial instruments. This reflects the relative usefulness of historical cost and fair value for different instruments depending on factors such as:

- the business model for managing the instruments;
- whether the instruments are held for resale; or
- whether they are derivative instruments (in which case, historical cost is often particularly uninformative).

28. We think that the objections to complexity in this area are somewhat overstated. Financial instruments are often complex and difficult to value and a degree of complexity in reporting them adequately has to be expected. Also, as we explain in our comments on the discussion paper, fair value itself can be complex, requiring extensive disclosures and meaning different things in different contexts. It would be naïve to imagine that use of fair value for all financial instruments would present the users of financial reporting information with something that could be understood easily.
29. Nor do we think that it would be sensible to set an 'end goal' for reporting financial instruments that is significantly different from what seems to be the best solution in current circumstances. Any such plan for the future seems to involve unwarranted assumptions about changes to those circumstances. If circumstances do change, the question of how, if at all, financial reporting needs to change to reflect them will be best addressed at the time, rather than some years in advance.
30. We also think that further questions on the balance between fair value and historical cost will depend on how gains and losses arising on movements in fair value are treated in the income statement, in terms of the extent to which users want to distinguish them from other gains and losses. We therefore believe the IASB needs to progress its project on financial statement presentation in terms of resolving how the statement of comprehensive income should best be structured. In addition, classification cannot be considered in isolation from hedge accounting, which is probably the most complex area of IAS 39. Therefore, we would not expect changes to classification, for example, to reduce the number of categories, to be possible in the very short term since presentation and hedge accounting will also need to be addressed.
31. Turning to improvements to fair value accounting we believe are essential, simplifying the measurement of financial assets and liabilities by allowing only two alternatives - amortised historical cost less impairment or fair value through the income statement - would be a major step forward, assuming that alternatives can be developed based on clear principles that will result in a significant improvement to financial reporting. This would certainly do away with the recycling issue (except for cash flow hedges). We do, however, see a problem in fair valuing liabilities through the income statement. Not only are the current gains caused by widening spreads confusing, but their reversal when markets recover may well mask a bank's improving fortunes, thus potentially delaying economic recovery even further. Again, though, this concern might be addressed by an approach to income statement presentation which usefully disaggregated and described these types of gains

and losses. We would also support in principle moving to one model for impairment. Naturally, the views we express in this paragraph can only be tentative; we would need to examine detailed proposals in due course to ensure that an appropriate balance has been struck between complexity and the need for requirements on the reporting - or non-reporting - of gains and losses that make good sense, particularly in relation to gains and losses reported in relation to movements in credit risk on own debt.

Question 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?

32. We believe that genuine emergency issues in accounting are very rare. The 'emergency' that arose in autumn 2008 was the desire of certain financial institutions to avoid reporting the losses that they expected to have to report under then existing requirements. We can understand why such institutions and their managers might view this as an emergency, and the IASB should perhaps have reacted more quickly to the concerns raised, even if the final decision was to stick with the existing rules. In the end, however, what turned it into an emergency for the IASB was the high-level political support that these institutions were able to enlist, rather than the merits of the case.
33. The IASB and the IASCF Trustees should continue to focus on doing everything possible to ensure that the standard setting process, including the overarching governance framework, is as robust and credible as possible, thus reducing the likelihood of genuine emergencies arising from technical problems in the first place. This means setting clear and understandable standards based on well-articulated principles, field testing with preparers and users, listening and reacting to feedback (particularly on anticipated or actual problems of implementation), and even testing draft standards against "what if" scenarios of different macro economic conditions (the latter possibly in conjunction with prudential regulators). They will then be better placed to respond to political pressures for changes to accounting standards where these are not underpinned by valid technical analysis.
34. In the event of a genuine emergency, the IASB needs to consider two issues in the first place:
- What damage would be likely to be caused by a failure to act?
 - How rapid would appropriate action have to be?

In such an emergency, neither of these judgements is likely to be straightforward as much is likely to depend on the actions of other players – eg, governments and regulators – and such situations are usually characterised by a high degree of uncertainty. However, a view will have to be taken.

35. Where, because of a genuine emergency, full due-process consultation with interested parties would be inappropriate, the IASB should consider two alternatives:

- (a) a shorter process of public consultation; or
- (b) a shorter process of private consultation with key interested parties.

The route chosen will depend on how serious and urgent the emergency is. But, other things being equal, a longer consultation – albeit shorter than the usual period – is better than a shorter one, and a public consultation is better than a private one.

Question 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?

- 36. We are unable to identify any such issues. The more likely scenario, particularly with dynamic provisioning or Economic Cycle Reserving, is that the IASB and FASB will be asked – wrongly in our view - to put things into accounting standards that are actually to do with prudential regulation. These will obscure accounts for investors and would be better dealt with by prudential regulators through their own regulatory mechanisms.
- 37. The IASB should be the sole arbiter in relation to IFRS and should not deal with issues beyond its remit, but nevertheless should liaise with those regulators and other bodies that have a legitimate interest in financial statements to ensure the IASB is aware of linkages to other regulation and the legitimate concerns of these bodies. Harmonising requirements where possible is obviously an advantage to all; but we reiterate that the needs of investors for general purpose financial statements should be paramount.

Question 7

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

- 38. We have no further comments, except to say that in our view the IASB is now in general dealing promptly and appropriately with the issues arising from the current crisis, other than the regrettable instance where it felt obliged to completely suspend due process.

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