The Corporate Reporting Users' Forum

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Banking Standards – Tax, Audit & Accounting

Q10 What was the role of accounting standards and reliance on fair value principles in the banking crisis? What does a "true and fair view" really represent to the market?

There is good academic and practical evidence that fair values, to the extent that they are applied in IFRS, have if anything had a positive impact on banks during the crisis and since. It is notable that the US and UK banks, which have enjoyed much less flexibility from their regulators in the application of fair valuations to their balance sheets, have been quicker to address their problems and to seek necessary resolutions to the difficult situations that they have faced. Continental European banks, which in a number of cases have been facilitated by their regulators to ignore the fair valuations of their portfolios, have in some instances therefore not acknowledged their problems and have thus been slower to address them. They remain in an unhealthy state – and largely untrusted by the markets – as a result. This plays an important role in the continuing crisis of confidence in Continental European banks.

The negative influence of fair value accounting in fuelling the bubble of activity ahead of the crisis has been less actively considered by academics but practical experience is suggestive that it did play some role. This role was part of a complex system which actively encouraged the continuation of activity at a level of intensity which was, with the benefit of hindsight, wholly inappropriate. Other elements of this systemic failure were: central banks which kept interest rates at levels which were too low and encouraged a binge of borrowing; the bulk of investors encouraging banks to continue with their level of lending and other activities, and indeed encouraging them to add leverage; and regulators which failed to supervise effectively and intervene at an early enough stage. The role of fair value accounting in comparison with any one of these other elements was extremely limited.

The true and fair view is valued as a cornerstone of the English law surrounding financial reporting and the accounting that we expect of our companies. We welcome companies and their auditors looking beyond the accounting rules and delivering accounts which accurately and appropriately reflect the substance of their activities and their current position. IFRS itself acknowledges this need to ensure that accounts reflect the underlying substance, but we note that the override which is available under the standard is very rarely used; it is at least arguable that it should have been used more actively when markets were as dislocated as they were in the crisis. This would have been preferable to the extent of reclassification applied by the banks.

Q11 What are your views on the current incurred-loss impairment model and its role in the banking crisis? Do you consider that proposals to move to an expected-loss model will address criticisms of the current accounting rules?

We believe that the incurred loss model has been wholly discredited and firmly support moves to introduce an expected loss model. We have urged the IASB to act on this issue and to deliver its expected loss model as soon as possible. We have welcomed the IASB's proposals on expected value accounting and believe that they will address the deficiencies in the current approach.

However, it is worth emphasising that we do not believe that the incurred loss model was a material factor in the banking crisis. In the run up to the crisis we do not believe banks would have booked materially higher provisions if using an expected loss model since they would probably not have foreseen an increased level of losses. However, once the crisis broke we believe the incurred loss model allowed banks to avoid recognising losses to the extent that prudence would have suggested was appropriate (on the basis that they had not yet been incurred even though they might reasonably be expected).

It is worth noting that an expected loss model might be considered to be more 'pro-cyclical' in this respect than an incurred loss model, and on that basis will not address the criticisms of those who would prefer a deliberately counter-cyclical 'dynamic reserving' approach whereby profits were taken to reserves in the good years to be released during hard times. While this may be an appropriate regulatory capital approach we do not wish to see such an approach mandated for accounting purposes.

Q12 What is the best method of accounting for profits and losses in trading instruments? Are there any alternatives to mark-to-market or mark-to-model that might better represent a "true and fair view"?

We see no practical alternative to the current value approach for the valuation of trading financial instruments. This is the right framework to provide shareholders with appropriate information on such assets, on the basis of which to call management to account. How current values are calculated and the disclosure which accompanies them is more open to debate. Where markets operate, are liquid and relatively efficient the market price makes sense (though perhaps some indication of the volatility of these prices and so the impact of the particular balance sheet date on the pricing would be useful). Marking to model in its various forms, particularly when markets are non-existent or not operating properly, is more problematic and requires greater levels of disclosure of sensitivity analyses and volatilities such that the uncertainties of the published numbers are more clear and auditors and investors have a firmer basis to discipline companies to disclose the most appropriate valuations as their central estimate.

Q13 Did IFRS accounting standards contribute to a box-ticking culture to the exclusion of promoting transparency and a “true and fair view” of the business?

We have seen no evidence that IFRS has contributed to a box-ticking culture and do not believe that it works to obscure the reality of businesses.

Q14 Do we need a special accounting regime for banks? If so, what should it look like?

No, we would not welcome a special accounting regime for banks, though members of the CRUF have worked, not least through the Financial Stability Board's Enhanced Disclosure Task Force, to promote higher quality disclosures by banks of matters which are specifically relevant to the industry. We would also note the need for a bank-specific approach with regard to the issue of going concern given the particular challenges faced by the banking industry in this regard. Beyond this, we do not think that it would be welcome to have a bank-specific accounting regime.

Q15 Are there any interim measures (such as mandatory disclosure) which could be introduced in the meantime?

We commend the work of the Enhanced Disclosure Task Force to the Commission; we believe that the disclosures encouraged under this would significantly enhance the transparency of bank reporting and, if delivered by the banks, would rebuild market confidence in the industry. We encourage banks worldwide to seek to live up to this best practice guidance and we understand that the FSA is actively considering providing similar encouragement to UK banks in particular. We also understand that the FSA will encourage banks to disclose according to the expected loss model even before it comes into effect; we believe that this too is a welcome step.

About the Corporate Reporting Users’ Forum (CRUF)

The CRUF came together in 2005 as a discussion forum to help its participants in their approach to the debate on current and future corporate reporting requirements. In particular, participants are keen to have a fuller input into the deliberations of accounting standard setters such as the IASB and FASB.

CRUF participants come from all around the world, including individuals from both buy- and sell-side institutions, and from both equity and fixed income markets.

The CRUF is a discussion forum. Different individuals take leadership in discussions on different topics and in the initial drafting of representations. It does not seek to achieve consensus views, though at times some or all of its participants will agree to make joint representations to standard setters or to the media. It would not be correct to assume that those individuals who do not participate in a given initiative disagree with that initiative.

We sign this letter in our individual capacity as participants of the Corporate Reporting Users' Forum (www.CRUF.com) and not as representatives of our respective organizations. The views expressed are those of individual CRUF participants and do not necessarily reflect the views of the respective organisations where we are employed.

The participants in the Forum that have specifically endorsed this response are listed below.

Yours sincerely

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