The Corporate Reporting Users' Forum

Briefing for Members of the European Parliament

Financial Reporting and User Confidence during market turmoil

November 2008

In the current climate it is essential that the markets can trust the financial data reported by companies – the risks associated with unwarranted rule changes far outweigh any cosmetic benefits.

Participants at the EU Commission's recent stakeholder meeting overwhelmingly supported the view that due process be upheld. Any "quick fix" produced under time pressure is almost guaranteed to result in a suboptimal solution which will confuse users and reduce comparability (both with US GAAP and amongst IFRS reporters).

We would thus urge the Parliament not to place emphasis on a December 31st deadline for resolution of the issues identified in the European Commission's letter of 27 October and instead to give prominence to the need to ensure that the resulting standards will stand the test of time. Given the complexity of some of the issues raised, finding a solution that works for all key stakeholders in the reporting model may take longer than the two month period proposed.

ACCOUNTING IN THE CONTEXT OF MARKET TURMOIL

Although the current credit crisis requires swift measures by governments and regulators in the context of liquidity and capital, fundamental changes in accounting should be implemented only after due process and involvement of all stakeholders. We believe that the positive actions to mitigate the crisis taken by the EU and the Member States would be undermined if trust in the accounting numbers were eroded.

The risk of creating accounting rules that allow companies to time the recognition of losses and gains to their advantage could have an impact on the quality of European financial reporting for years to come as companies unwind their current positions. This could push back the point at which investor trust and thus market confidence are restored to a much later date than would otherwise be the case. The implications of this for European capital markets and thus European economic growth would be serious indeed.

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FURTHER ADJUSTMENTS NOT NEEDED

Though we are very concerned about the suspension of due process, by permitting the reclassification of financial instruments on October 13th, the IASB has removed a potentially unhelpful inequality between the two regimes.

We believe that any further changes should be made only after due process has been observed, allowing proper consultation with stakeholders including investors; otherwise there is a serious risk of unintended consequences in this highly complex subject. Any changes should be made only if they have economic merit and a material impact on a number of European entities. Furthermore, if market participants are to trust the resultant financial statements, any changes made should aim to limit management's ability to "cherry pick" the numbers reported.

ROOM FOR EARNINGS MANAGEMENT

Allowing more room to shift financial instruments between the categories measured at fair value and historical cost gives management greater opportunity for earnings management. We understand the desire to avoid "meaningless" volatility and/or marking to distressed asset prices but we believe explanation and disclosure is the solution, not further flexibility which may encourage managements to report good news whilst hiding bad news. Increasing the opacity of reported figures is not the way to enhance credibility and, in the absence of believable reported data, market participants will simply synthesise information on their own based on potentially incorrect assumptions and rumours.

COMPARABILITY WITH US GAAP

A unilateral carve-out would increase the differences between US GAAP and IFRS. This would reduce the comparability between the two sets of accounting standards just when comparability is needed most. A perception of greater flexibility in EU-IFRS could put European companies at a competitive disadvantage relative to their US peers.

IFRS EXTENDS BEYOND EUROPE

IFRS is quickly becoming the world's global accounting standard, due in no small part to the vision and leadership shown by the European Union and its institutions. If Europe adopts its own version of IFRS, we risk detaching ourselves from this global movement and sacrificing our position of influence for one on the sidelines, just at the point when the global economy needs strong leadership in all areas, including accounting. European investment institutions and their advisers already benefit significantly from the fact that we are familiar with IFRS and so can easily work with IFRS data produced by companies outside the EU. If Europe diverges from the IFRS practiced elsewhere in the world, this advantage will be lost and the cost will be felt by European pension funds.

REGULATORY FLAWS NOT ACCOUNTING

The crisis in the insurance industry in 2003 was solved not through changes to the accounting standards, but through a review of the appropriateness of the regulations governing their solvency requirements.

Regulators can have accounts restated to reflect their view of realistic outcomes, adjusting the cost of risk versus what is discounted in current market values. They should manage capital adequacy based on these numbers and the projected cash flows of the underlying assets. This might have prevented the excessive issuance of credit in the past when credit spreads became too narrow and banks appeared stronger compared to long run averages. Equally it could improve an assessment of the capital position currently when, arguably, credit spreads are too wide in illiquid markets.

Changing accounting is not the answer. Accounts should reflect the current situation at the balance sheet date and performance over the prior period so that shareholders understand the exposures. If companies chose, or were required, to disclose the regulatory (projected cash flow) valuation of their assets as well, then users could interpret the accounting data in the light of this additional information.

We readily acknowledge that IFRS standards, including IAS39, are not perfect. And as users of accounting data, we strongly support any long-term action to improve corporate transparency. However, accounting was not the cause of – nor will it be the solution to - this crisis. We thus recommend that any issues with reporting standards be corrected through a process of stakeholder engagement with the IASB rather than unilateral EU action.

About the Corporate Reporting Users' Forum (CRUF)

Members of the CRUF include members of EFRAG's User Panel, the IASB's Analyst Representative Group, Standards Advisory Council and various working groups, as well as participating in national standard setting bodies.

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. 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, with meetings held in London and Frankfurt. The chairmanship of the CRUF rotates at each meeting and 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.

CRUF participants take part in discussions and joint representations as individuals, not as representatives of their employer organisations.

For further information on the issues above, please contact:

Dennis Jullens
European Head
UBS Valuation & Accounting Research
Dennis.Jullens@ubs.com
+ 31 6 2901 0769

Gunnar Miller
Head of European Research
Global Co-Head of Research
RCM-Allianz Global Investors
Gunnar.Miller@de.rcm.com
+ 49 69 263-14639

Jed Wrigley
Portfolio Manager
Director - Accounting & Valuation
Fidelity Investments
Jed.Wrigley@fil.com
+44 207 074 5204