Memorandum from the International Accounting Standards Board (IASB)

1. This memorandum sets out the response of the International Accounting Standards Board (IASB) to a number of questions set out in the call for evidence issued on 4 December 2012 by the Parliamentary Commission on Banking Standards' Panel on tax, audit and accounting.

About the IASB

2. Established in 2001, the IASB is the standard-setting body of the International Financial Reporting Standards (IFRS) Foundation, an independent private sector, not-for-profit organisation. The IASB is committed to develop, in the public interest, a single set of high-quality, understandable, enforceable and globally accepted financial reporting standards based upon clearly articulated principles. Those standards should serve investors and other market participants in making informed resource allocation and other economic decisions. The confidence of all users of financial statements is critically important for the effective functioning of capital markets, efficient capital allocation, global financial stability and sound economic growth.

3. In pursuit of this objective, the IASB develops its standards by conducting an extensive due process, which is founded on the principles of transparency, full and fair consultation and accountability.

4. IFRSs, as established by the IASB, are now used in more than 100 countries, including three quarters of the G20 and all the Member States of the European Union.

Global accounting standards

5. The G20 have made repeated calls for the achievement of a single set of high quality global accounting standards and they, together with the Financial Stability Board (FSB) have reinforced the importance of this as one of the financial regulatory reforms in response to the crisis. Academic research commissioned by the IFRS Foundation on the benefits and consequences of global accounting standards[1] demonstrates the benefits that can result from the adoption of IFRSs, in particular when IFRS application is supported by a framework that encompasses legal protections, competent professionals and adequate monitoring and enforcement.

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?

6. Accounting standards played a very limited part in the onset of the banking crisis. Although some assert that current accounting standards allowed banks to paint too rosy a picture of their true financial condition, there is very little evidence to support this assertion. Indeed, the financial statements of the banks prior to the crisis clearly showed that most banks were extremely leveraged and in a very perilous condition[2]. The balance sheets of many banks were supported by 2% of

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1 Tarca (2012) 'The Case for Global Accounting Standards: Arguments and Evidence', available at: http://www.ifrs.org/Use-around-the-world/Documents/Case-for-Global-Accounting-Standards-Arguments-and-Evidence.pdf.

2 See, for example, the FSA Board Report (December 2011) 'The failure of the Royal Bank of Scotland', Graph 2.1, Leverage for Selected Firms, taken from published annual accounts (page 67) http://www.fsa.gov.uk/library/other_publications/miscellaneous/2011/rbs.shtml.

tangible capital or even less, a degree of leverage which was unprecedented in economic history and clearly visible in financial statements. In retrospect, it is remarkable that market participants failed to pick up the very clear signals of excessive leverage in financial statements. One of the reasons why this did not happen was that many market participants were focussed on the so-called Basel capital ratios[3]. This regulatory measurement method allowed the banks to calculate their capital ratios on the basis of risk weighted assets. It is well documented how, before the crisis, the Basel capital ratios had been gamed to increase leverage by exploitation of the risk weights. Banks with a seemingly sound Tier-1 ratio of 10 per cent could in fact be leveraged 40 or 50 times. The Basel ratios had been abused as a scheme for hiding the excessive and very dangerous leverage which market participants could and should have observed in the financial statements of the banking industry.

7. As for reliance on fair value principles, it is not the case, as some have claimed, that the IASB is seeking a full fair value model for financial instruments. Both the existing standard IAS 39 *Financial Instruments: Recognition and Measurement* and as well as its replacement IFRS 9 *Financial Instruments* provide for a mixed attribute model. While fair value is an appropriate measurement attribute for financial instruments that are traded, in IFRS 9 financial instruments that have basic loan features and that are managed on a contractual yield basis are measured at amortised cost. For such instruments, amortised cost is deemed to provide more relevant information. It is the case that the majority of banks' financial assets are still valued on an amortised cost basis rather than fair value[4] and that many of the assets that have been written-down have been those held at amortised cost. For this reason, most academic evidence available shows that the claim that fair value accounting exacerbated the financial crisis appears to be largely unfounded[5].

9. In part, fair value accounting actually helped to reveal the crisis, in particular through requiring the banks to report losses earlier than under any other accounting basis, as was demonstrated by the recent write-downs of Greek sovereign debt. This had the benefit of focusing attention much earlier on the banks' business models and led to remedial action, such as capital raising, much sooner than otherwise would have been the case.

10. In sum, we do not support the notion that accounting standards led to a systemic bias to overly favourable financial statements in the banking industry. Clear signals that the banking industry was extremely leveraged were simply not picked up. However, we do acknowledge that the incurred loss model for the impairment of assets was in need of improvement. Indeed, the IASB is currently in the process of replacing the incurred loss model by an expected loss model. Our proposals to improve our standards in this respect are outlined in the answer to Question 11 below.

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[3] Formally the 'Revised Framework on International Convergence of Capital Measurement and Capital Standards' (Basel II) issued in June 2004 by Basel Committee on Banking Supervision.

[4] As reported in, for example, the final report of the Financial Crisis Advisory Group (July 2009), page 4 http://www.ifrs.org/News/Press-Releases/Documents/FCAGReportJuly2009.pdf

[5] See, for example, Laux and Leuz (2010) 'Did Fair-Value Accounting Contribute to the Financial Crisis?' (Journal of Economic Perspectives, Volume 24, Number 1, Winter 2010, pages 93-118) http://nd.edu/~carecob/April2011Conference/LeuzPaper.pdf

A true and fair view to the market?

12. The IASB develops standards that provide a faithful portrayal of an entity's financial position and performance in its financial statements. The application of IFRSs, with additional disclosures when necessary, is presumed to result in financial statements that achieve a fair presentation, which in our view represents a true and fair view to the market.

13. The UK Financial Reporting Council (FRC) sought Counsel's Opinion in 2008 on the issue of true and fair. The Opinion by Martin Moore QC[6] concluded that "the requirement set out in applicable accounting standards to present fairly is not a different requirement to that of showing a true and fair view, but is a different articulation of the same concept". Mr Moore's Opinion was made before changes were made to the IASB's Conceptual Framework in 2010 in which the qualitative characteristic of prudence was replaced by neutrality. Some take the view that this had rendered Mr Moore's Opinion out of date. However, we note that the importance of true and fair was reaffirmed by the FRC in a follow up paper in 2011[7] and – in that paper – the FRC, noting the change in the Framework, commented that: "However, in practice the concept of prudence continues to underlie the preparation of accounts under both UK GAAP and IFRS". We also note the view of the UK Government that IFRS has not led to a loss of prudence[8]. A recent speech by Hans Hoogervorst[9] maintained that, despite its removal from the Framework, the basic tenets of the concept of prudence remain intact and visible throughout IFRSs, for example in the IASB's proposals for leasing, under which entities will recognise on their balance sheets assets and liabilities arising from leases.

14. For IFRSs to be adopted legally for use in the European Union, each standard and Interpretation has to be endorsed by the European Commission. The endorsement criteria[10] include a requirement that each of them is 'not contrary' to the principle of providing a true and fair view as set out in the EU Accounting Directives. All the standards endorsed for use in the EU have met that criterion.

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?

15. A well-functioning impairment model is of paramount importance for an amortised cost measurement to be reliable and credible. The IASB acknowledges that the current incurred-loss impairment model was criticised after the outbreak of the crisis for being too little, too late.

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6 Available at: http://www.frc.org.uk/FRC-Documents/FRC/True-and-Fair-Opinion,-Moore,-21-April-2008.aspx

7 FRC (June 2011) 'True and Fair' http://www.frc.org.uk/FRC-Documents/FRC/Paper-True-and-Fair.aspx

8 Response of the UK Government to the House of Lords Economic Affairs Committee report 'Auditors: Market Concentration and their Role' (19 May 2011) http://www.publications.parliament.uk/pa/ld201012/ldselect/ldeconaf/157/15704.htm.

9 'The Concept of Prudence: dead or alive?' (18 September 2012) http://www.ifrs.org/Alerts/Conference/Pages/prudence-speech-Sept-2012.aspx

10 As set out in Regulation 1606/2002 of 19 July 2002 on the application of international accounting standards, Official Journal L243, 11 September 2002, pages 1-7.

16. We think that this criticism was partially justified[11]. There are a number of factors as to why the market capitalisation of many banks is far below their book value, only one of which relates to the view of market participants about the current level of provisions. One also needs to consider the risk premium now demanded by the market and which is factored into fair value but which, even with expected loss, would be absent from amortised cost. Also, another factor positively impacting book values is the continued recognition of intangibles, including goodwill, in bank balance sheets.

17. In the IASB's view, the incurred loss model could have been applied much more vigorously in the last couple of years, such as in the example of the late write-downs by banks of their holdings of Greek government bonds. Under the relevant standard IAS 39*,* an impairment is recognised if there is objective evidence that the loan has been impaired since the date it was originated. Some have read this as implying that a default has to occur for an allowance to be made. In fact the approach is to book allowances when there is "objective evidence" of impairment, which could for example be that the borrower is in "significant financial difficulty" rather than actual default.

18. That said, both the IASB and the FASB are convinced that we need a more forward-looking impairment model and the Boards have been working to develop an expected loss model. It is unfortunate that, after extensive work, the two Boards have been unable to agree on a converged proposal[12], but we will both shortly be publishing for public comment our respective proposals and seeking the views of constituents on them. Both Boards are acutely conscious of the need to make progress as quickly as possible on this important, but complex, issue.

19. The IASB believes that the introduction of an expected loss model will be a major improvement, for three reasons[13]. First, it should lead to provisions being made in a more timely and realistic fashion and a heightened, more forward-looking risk awareness in the financial industry. Secondly, a timely clean-up of the banking system should free up resources to viable sectors of the economy instead of exercising forbearance on essentially defunct companies. Thirdly and perhaps most importantly, is the damage to the credibility of the financial sector by the serial underestimation of the true magnitude of problematic assets. Partial recognition of inevitable losses may buy time in the short run, but in the end leads to round after round of 'definitive' rescue programmes and a gradual erosion of confidence in the markets.

20. It is obvious that for a rigorous and adequate application of the expected loss model, banks need to be properly capitalised, which is an issue the prudential regulators are seeking to address through the recent reforms of the Basel regime for capital requirements.

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'?

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[11] As acknowledged in a speech by IASB Chairman Hans Hoogervorst at the 3rd ECB Conference on Accounting, Financial Reporting and Corporate Governance for Central Banks, 4 June 2012 http://www.ifrs.org/Alerts/Conference/Pages/Hans-speech-4-June-2012.aspx.

[12] The IASB is proposing a 'three-bucket' approach, where an entity recognises a lifetime expected loss if credit quality and deterioration criteria are met, and a 12 month expected loss allowance for all other assets; the FASB approach is propose a model that reflects all credit risk in the portfolio at each reporting date, with impairment losses recognised when an entity originates or purchases a financial asset at fair value.

[13] As set out in Hans Hoogervorst's speech to the ECB, referenced in footnote 11.

21. For many financial instruments that are traded, there is no alternative to fair value. This was a point made in evidence to the Parliamentary Commission by both Hermes Equity Ownership Services and the Investment Management Association. IAS 39 requires that derivative financial instruments be recognised and measured at fair value as they are typically issued at a small cost, or even at zero, but they may have a significant value subsequently and at settlement. Applying a cost approach to their measurement would not reveal that potential impact to investors.

22. However, the global financial crisis highlighted the need for:

(a) clarifying how to measure fair value when the market for an asset or liability becomes less active; and
(b) improving the transparency of fair value measurements through disclosures about measurement uncertainty.

23. The IASB and FASB worked together to respond to these needs. In May 2011, the IASB issued IFRS 13 *Fair Value Measurement*, which explains how to measure fair value for financial reporting. IFRS 13 will help increase transparency when entities use models to measure fair value, particularly when users need more information about measurement uncertainty, such as when a market becomes less active. The standard requires entities to disclose information about the valuation techniques and inputs used to measure fair value, as well as information about the uncertainty inherent in fair value measurements. The IASB believes that providing additional information about fair value measurements to users of financial statements will help improve confidence in those measurements, especially those at 'Level 3' of the fair-value hierarchy, which relies on unobservable inputs for the asset or liability, including an entity's own data. That said, few banks make extensive use of Level 3. Research undertaken by JP Morgan Cazenove of the 2011 Annual Reports of European banks[14] reveals that, on an unweighted average basis, Level 3 assets represented around 3 per cent of financial assets. Of the major UK banks, Barclays had the highest proportion, with 4 per cent.

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

24. The IASB has always advocated financial reporting requirements that account for transactions and activities across industries, rather than developing industry-specific guidance. We believe that such as approach avoids the proliferation of potentially conflicting industry-specific requirements. In a recent report[15], the IFRS Foundation staff noted that, 2008, the US Securities and Exchange Commission (SEC) published the findings of the Pozen Report[16], which recommended that industry guidance should be eliminated from US GAAP to reduce avoidable complexity. The Pozen Report went on to recommend that the SEC should encourage the IASB to limit future industry-specific guidance.

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[14] JP Morgan Cazenove (August 2012) – Europe Equity Research 'Financial Instruments disclosure analysis'.

[15] IFRS Foundation (October 2012) 'Report to the Trustees of the IFRS Foundation: IFRS Foundation staff analysis of the SEC Final Staff Report – Work Plan for the consideration of incorporating IFRS into the financial reporting system for US issuers' http://www.ifrs.org/Alerts/PressRelease/Pages/IFRS-Foundation-Staff-Analysis-of-SEC-Final-Staff-Report-on-IFRS.aspx.

[16] Report of the Advisory Committee on Improvements to Financial Reporting to the US SEC (August 2008) http://www.sec.gov/about/offices/oca/acifr/acifr-finalreport.pdf

25. That said, while the IFRSs on financial instruments are applicable to all entities that have financial assets and financial liabilities, they have particular relevance for the financial statements of financial institutions, including the banks. These standards have been written with what their effects on the banking industry will be very much in mind. For example, much of the IASB's outreach in developing its proposals on impairment has been with the financial sector and its prudential regulators, particularly through an enhanced dialogue with the FSB and the Bank for International Settlements. As the report of the Financial Crisis Advisory Group (FCAG)[17] made clear, "prudential regulators could benefit from the insight of accounting standard setters in making regulatory requirements (such as the Basel ratios) more transparent", although the FCAG cautioned that such requirements must be made in a manner that does not compromise the transparency and integrity of financial reporting.

26. We note that the final report of the Sharman Inquiry[18], launched by the UK FRC in 2011, addressed the issue of whether there should be a separate financial reporting and auditing regime for banks. The report noted that most commentators to the Inquiry thought that, as financial reporting and auditing standards have been developed in order to be applicable to all types of business, no separate industry specific standards should be developed as this would restrict the comparability of financial reports. As some groups of companies have banking components as well as businesses in other sectors, the Sharman report observed that "it may be problematic to draw boundaries around the entity to be reported separately".

27. It was also pointed out to the Panel of Inquiry that the growing regulatory requirements already offer the potential to develop an incremental (if not separate) financial reporting and auditing regime through the regulatory returns that are required. For example, the regulator has the ability to require banks to provide incremental information that may also be relevant to the markets.

28. We agree with the views reported in the Sharman Report.

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

29. On 29 October 2012 the FSB, of which the IASB is a plenary member, announced the publication of the Report of the Enhanced Disclosure Task Force (EDTF)[19]. The EDTF was formed at the initiative of the FSB in May 2012 to investigate ways in which to improve the quality of risk disclosures for banks. The Report includes a number of recommendations aimed at enhancing the clarity, comparability and timeliness of information that banks provide to their investors. The IASB has commended the issue of this Report as complementing our own efforts to enhance transparency and the usefulness and comparability of financial statements. Furthermore, the IASB has recently

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[17] The FCAG was a high-level group, formed at the request of the IASB and the US FASB, to consider financial reporting issues arising from the crisis. Its' report was published in July 2009: http://www.ifrs.org/News/Press-Releases/Pages/Financial-Crisis-Advisory-Group-publishes-wide-ranging-review-of-standard-setting-activities-followi.aspx.

[18] The Sharman Inquiry (June 2012) 'Going Concern and Liquidity Risks: Lessons for Companies and Auditors – Final Report and Recommendations of the Panel of Inquiry' http://www.frc.org.uk/getattachment/591a5e2a-35d7-4470-a46c-30c0d8ca2a14/Sharman-Inquiry-Final-Report.aspx.

[19] Financial Stability Board (October 2012) 'Enhancing the Risk Disclosure of Banks: Report of the Enhanced Disclosure Task Force' http://www.financialstabilityboard.org/publications/r_121029.pdf

started a revision of its Conceptual Framework and will consider the EDTF recommendations as it develops new financial reporting disclosure principles