

HOUSE OF COMMONS TREASURY COMMITTEE

**BANKING CRISIS INQUIRY:
ACCOUNTING AND THE BANKING CRISIS**

**MEMORANDUM SUBMITTED BY
THE UK FINANCIAL REPORTING COUNCIL (FRC)**

November 2008

Introduction

1. This paper responds to an invitation dated 28 October 2008 for the submission of written evidence in connection with the Treasury Committee's hearing on accountancy in the context of the current banking crisis, to be held on 11 November 2008.
2. This structure of this paper is as follows:
 - a. Key Points (paragraph 3);
 - b. Executive Summary (paragraphs 4-12);
 - c. Background information on the Financial Reporting Council (FRC) and its relevant operating bodies, including the Accounting Standards Board (ASB) (paragraphs 13-22);
 - d. The purpose, and intended audience of, financial accounts, including the role of accounting standards and the role of narrative reporting (paragraphs 23-39);
 - e. The role that fair value accounting has played in the banking crisis, and whether any change to fair value reporting rules and requirements is appropriate (paragraphs 40-72);
 - f. The role and accountability of the International Accounting Standards Board (IASB) (paragraphs 73-80);
 - g. The process of developing and/or amending accounting standards (paragraphs 81-87); and
 - h. The purpose, and intended audience of, statutory audit (paragraphs 88-99).

Key Points

3. The key points the FRC wishes to highlight from this paper are:
 - a. The FRC is an independent regulator, supported by a range of statutory and non-statutory powers which contribute to confidence in corporate reporting and governance;
 - b. Financial accounting aims to reflect economic reality in an unbiased way which can be useful for decision-making by investors and other users;

- c. Accounting standards should be based on clear principles and acknowledge that there can be a variety of potentially acceptable accounting methods, so that choices have to be made as to which best portrays economic reality in order for the financial statements to present a true and fair view;
- d. Accounting standards are best developed by an independent standard-setter, such as the IASB, supported by effective consultation with the market, rather than by any particular interest group who may find it too difficult to be objective;
- e. Financial statements need to be supplemented by other information, in particular a narrative explanation of a company's development, performance, position and prospects;
- f. The use of fair value for the reporting of a range of financial instruments is appropriate and preferable to any alternative basis, as it both reflects the economics of the underlying transactions and provides accurate, timely and comparable information to investors;
- g. The FRC does not believe that financial reporting, in particular fair value accounting, has caused the current market turmoil, but acknowledges that there is a need for the IASB to review existing requirements to see if improvements can be made. Changes should not be made unilaterally by other authorities or regulators;
- h. Public confidence in the operation of the capital markets depends on the credibility of financial reporting. **Independent** assurance provided by an audit that the financial statements have been prepared properly and the opinion as to whether they give a true and fair view is key to this credibility;
- i. Audit regulators have an important role to play in promoting confidence in audit through the establishment of standards and monitoring the audits of listed and major public interest entities.

Executive Summary

The FRC

4. The FRC is the UK's independent regulator of corporate reporting and governance. Working mainly through its operating bodies, and supported by a range of statutory and non-statutory powers, the FRC's aim is to strengthen confidence in corporate reporting and governance by promoting high-quality corporate governance, corporate reporting, auditing and actuarial practice, and by promoting the integrity, competence and transparency of the accountancy and actuarial professions (paragraphs 13-21). The FRC and its operating bodies have played an active role in monitoring the accounting and auditing implications of the current financial crisis and have taken a range of actions (paragraph 22).

The purpose, and intended audience of, financial accounts

5. Effective financial reporting is essential for the efficient operation of capital markets. Financial reports provide a vital communication link between companies and market participants, in order that investors (as the primary users) and other users can make economic decisions and assess the stewardship of management. There is an important distinction to be made between financial reporting and regulatory reporting (paragraphs 23-30)

6. Accounting standards, based on clear principles, set the requirements for the provision of high quality, transparent and comparable information that meets the purpose outlined above. Compliance with accounting standards is normally necessary for financial statements to give a 'true and fair view' as required by law (paragraphs 31-34).

7. That said, financial statements have their limitations and do not meet all the information needs of users, which is why the FRC has encouraged the publication of a narrative explanation of a company's development, performance, position and prospects as an important element of best practice. In the current market conditions, the provision of such an explanation becomes even more important (paragraphs 35-39).

The role that fair value accounting has played in the banking crisis and whether any changes are required

8. The objective of using fair value in financial statements for financial instruments is to provide a current value so that financial statements provide accurate, timely and comparable information on these instruments, which reflects the economics of the underlying transactions. Use of fair value ensures that readers of the financial statements are aware of the potential value and losses arising from financial instruments. In the current market conditions, the application of fair value accounting has led to the banks in particular reporting losses earlier than on any other accounting bases. This has had the benefit of focusing attention much earlier on the banks' business models and facilitated remedial action, such as capital raising, much sooner than would otherwise have been the case (paragraphs 40-55).

9. The FRC does not believe that financial reporting, in particular fair value accounting for financial instruments, has caused the current market turmoil, as some have claimed. The FRC believes that the use of fair value accounting is appropriate for a range of financial instruments, particularly those that are traded in active markets or where entities otherwise manage them on a fair value basis. That said, the FRC does acknowledge that there is a need to review the existing requirements in the light of the experience of the current market turmoil, to see if any improvements can be made, and notes

the calls that have been made for changes to be made to the relevant accounting requirements (paragraphs 56-72).

The role and accountability of the IASB

10. The FRC supports the work that the IASB has undertaken towards achieving the vision of a single set of high quality, global accounting standards for use by market participants in the world's capital markets (paragraphs 73-76). The FRC notes that the structure of the IASC Foundation is designed to ensure that the IASB is governed in a legitimate manner and welcomes the proposals that have been made by the Trustees to establish a formal public accountability link through the establishment of a Monitoring Group (paragraphs 77-80).

The processes for developing and/or amending accounting standards

11. The FRC notes that the IASC Foundation has put in place extensive procedures to ensure proper due process by the IASB. The FRC supports those due process procedures. The FRC notes, and supports, the suspension of the normal due process in the recent issue of amendments on the reclassification of financial instruments, in order to address the rare circumstances of the current credit crisis. But the FRC would be concerned if this created an unfortunate precedent for any further suspension of due process (paragraphs 81-87).

The purpose, and intended audience of, statutory audit

12. The primary purpose of an audit of the financial statements is for the auditor to provide independent assurance to the shareholders that the directors have prepared the financial statements properly in accordance with the accounting framework. As required by legislation, the auditor issues an opinion as to whether or not the financial statements give a true and fair view (paragraphs 88-89). Audit regulators have an important role to play in promoting confidence in audit through the establishment of standards and monitoring the audits of listed and major public interest entities (paragraphs 90-99).

About the Financial Reporting Council (FRC)

13. The Financial Reporting Council (FRC) is the UK's independent regulator responsible for corporate reporting and governance. Its functions are exercised principally by its operating bodies (the Accounting Standards Board, the Auditing Practices Board, the Board for Actuarial Standards, the Financial Reporting Review Panel, the Professional Oversight Board and the Accountancy and Actuarial Discipline Board) and by the FRC Board. The Committee on Corporate Governance assists the Board in its work on corporate governance. The FRC has a range of powers, some of which have a

statutory basis, and is sponsored by both the Department for Business, Enterprise and Regulatory Reform (BERR) and HM Treasury.

14. Confidence in corporate reporting and governance is a fundamental prerequisite for the effective functioning of the economy and financial markets. The FRC's aim is to strengthen that confidence by promoting high-quality corporate governance, corporate reporting, auditing and actuarial practice, and by promoting the integrity, competence and transparency of the accountancy and actuarial professions.

15. Among its responsibilities, the FRC:

- sets standards for financial reporting through the ASB;
- seeks to ensure, through the Financial Reporting Review Panel (FRRP), that the annual accounts of public companies and large private companies comply with the requirements of the Companies Act 2006 and applicable accounting standards;
- sets auditing standards through the Auditing Practices Board (APB);
- monitors and, where appropriate, enforces the application of auditing standards by the Professional Oversight Board (POB) through its Audit Inspection Unit (AIU);
- operates an independent investigation and disciplinary scheme; and
- sets and monitors the Combined Code on Corporate Governance through the Committee on Corporate Governance and the FRC Board.

More detail on the FRC, its operating bodies, and its aim and objectives is provided in Appendix A.

16. The ASB is the operating body of the FRC which has responsibility for accounting standards. It sets Financial Reporting Standards (FRSs) for all UK companies except for consolidated accounts of publicly traded companies, which since 2005 are required under EU law to apply International Financial Reporting Standards (IFRS) endorsed for use in the EU (EU-adopted IFRS). Apart from developing a strategy for the future of UK standards and their convergence with IFRS, the ASB's major activities since 2005 have focused on:

- seeking to influence the International Accounting Standards Board (IASB) (and the US Financial Accounting Standards Board, FASB) on the development of IFRS and a revised conceptual framework; and
- playing a leading role in Europe, in particular with the European Financial Reporting Advisory Group (EFRAG), both to ensure appropriate European influence in the development of international standards and their adoption in the EU.

Further detail of the history of the development of accounting standard setting in the UK is given in Appendix A.

17. The FRRP (the Panel) is the operating body of the FRC which has statutory responsibility, delegated by the Secretary of State for Business, Enterprise and Regulatory Reform, for reviewing company accounts for compliance with the Companies Act 2006 (the Act) and accounting standards. The role of the Panel is to examine the annual accounts of public and large private companies to see whether they comply with the requirements of the Act including applicable accounting standards. Following implementation of the Accounting Regulation (EC) No 1606/2002, this may mean compliance with UK Generally Accepted Accounting Practice (GAAP) or IFRS. The remit of the Panel was extended in 2006 to include the contents of directors' reports.

18. Sectors are selected by the Panel following a risk-based assessment made after discussion with the Financial Services Authority and the FRC's Standing Advisory Group, an independent committee. Where breaches of the Act are discovered the Panel seeks to take corrective action that is proportionate to the nature and effect of the defects, taking account of market and user needs. Where a company's accounts are defective in a material respect the Panel will, wherever possible, try to secure their revision by voluntary means, but if this approach fails the Panel is empowered to make an application to the court under section 456 of the Act for an order for revision. To date no court applications have been made.

19. The Panel does not offer advice on the application of accounting standards or the Companies Act. The Panel's operating procedures, which have been approved by the Secretary of State, can be found on its website: <http://www.frc.org.uk/frp/index.cfm>. Section 459 of the Companies Act 2006 gives the FRRP certain powers to require the provision of documents, information and explanations. The Panel is restricted from disclosing information so supplied except to those persons and for the purposes set out in Section 461 - namely for the purposes of performing its functions and disclosure to other regulators. The Panel's operating procedures state that save as specifically stated in those procedures, the Panel will treat all information obtained by it in the exercise of its functions as if it were subject to the restrictions on information received as a result of the exercise of its statutory powers, whether or not it is subject to those restrictions as a matter of law. The purpose of this provision is to protect those who supply the Panel with information without requiring the Panel to exercise its statutory powers. In practice, therefore, the Panel is prohibited from disclosing any information received from companies except where expressly permitted under Section 461 of the Act.

20. The APB is the operating body of the FRC which has responsibility for setting auditing standards. It issues standards and guidance for auditing, for the work of reporting accountants in connection with investment circulars, and for auditors' integrity, objectivity and independence.

21. The POB provides independent oversight of the regulation of accountants and actuaries by their respective professional bodies. It provides statutory oversight of the regulation of the auditing profession by the recognised supervisory and qualifying bodies, and, through the AIU, monitors the quality of the auditing function in relation to economically significant entities. Under the Companies Act 2006 (Section 1224A), there are statutory provisions that prohibit the disclosure of certain information in the discharge of the POB's functions.

22. The FRC and its operating bodies have played an active role in monitoring the accounting and auditing implications of the current financial crisis. In particular:

- The FRC issued guidance in December 2007 highlighting the challenges of corporate reporting and governance in the following year and will shortly be issuing updated guidance for audit committees highlighting challenges arising from the current economic conditions;
- The ASB has actively supported the work of the IASB and EFRAG on these issues, as well as monitoring and influencing UK attitudes. In October 2008, the ASB issued amendments to its standards on the reclassification of financial instruments;
- During the year 1 April 2006 to 31 March 2007, the Panel reviewed the accounts of 16 banks reporting under IFRS, including retail and investment banks and finance subsidiaries of overseas banks and large UK retail companies. Points identified by the Panel indicated a need for refinement of some disclosures in certain cases rather than for significant changes. The issues raised varied between banks and there was no evidence of any systemic reporting weaknesses. During the year to March 2008, the Panel reviewed the accounts of 10 retail and investment banks reporting under IFRS. The Panel considered compliance with all applicable reporting standards. As in the previous year, issues raised varied between banks and there was no evidence of systemic reporting weaknesses. Most of the points raised indicated a need for refinement of certain disclosures rather than significant changes in recognition or measurement policies;
- The FRRP announced on 9 November 2007 that its review activity in 2008 and 2009 would focus on the banking sector (and four other sectors). This work is progressing in accordance with the Panel's normal operating procedures. In its press notice of 30 October 2008, the FRRP announced that banking would continue to be a focus of its work for 2009 and 2010;
- The APB issued in January 2008 a Bulletin on 'Audit issues when financial market conditions are difficult and credit facilities may be restricted'; and

- The AIU responded to the heightened audit risk posed by the credit market turbulence by discussing with the major audit firms their preparations for ensuring their audit teams were adequately prepared for the risks relevant to the December 2007 reporting cycle, enhancing their risk based approach to the selection of individual audits for review and tailoring their work programmes to ensure increased focus on individual reviews on the relevant risks.

The purpose, and intended audience of, financial accounts

23. Effective financial reporting has been described as being essential for the efficient operation of capital markets¹. Financial reports provide a vital communication link between companies and market participants.

24. Both the IASB and the ASB have conceptual frameworks to assist them in the development of accounting standards: the IASB has a 'Framework for the Preparation and Presentation of Financial Statements' (the Framework) and the ASB's counterpart is known as 'Statement of Principles for Financial Reporting'. The frameworks deal in particular with:

- a. the objective of financial statements;
- b. the qualitative characteristics that determine the usefulness of information in financial statements, notably that the information needs to be relevant, reliable, comparable and understandable; and
- c. the definition, recognition and measurement of the elements from which financial statements are constructed.

25. One aim is to ensure that the information resulting from the application of accounting standards faithfully represents the underlying commercial activity. Such information should be neutral in the sense that it is free from any form of bias intended to influence users in a particular direction and should not be designed to favour any particular group of market participants, such as preparers or users. That is reflected in recent statements from a number of commentators, including the FRC², to the effect that the most appropriate accounting standards are developed when standard setters are able to exercise independent judgment, relying on their skills and experience and supported by effective consultation with market participants and other stakeholders.

26. The objective of financial statements, and who the users are of those statements, is considered in both the frameworks. The objective of financial statements is described in the IASB's current Framework as follows:

¹ Co-ordinating Group on Audit and Accounting Issues (CGAA) 'Final Report to the Secretary of State for Trade and Industry and the Chancellor of the Exchequer' (29 January 2003) (URN 03/567)

² FRC Press Notice 244 dated 24 October 2008 'FRC Statement on Development of Accounting Standards'.

“The objective of 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.

Financial statements prepared for this purpose meet the common needs of most users. However, financial statements do not provide all the information that users may need to make economic decisions since they largely portray the financial effects of past events and do not necessarily provide non-financial information.

Financial statements also show the results of the stewardship of management, or the accountability of management for the resources entrusted to it. Those users who wish to assess the stewardship or accountability of management do so in order that they may make economic decisions; these decisions may include, for example, whether to hold or sell their investment in the entity or whether to reappoint or replace the management” (Framework, paragraphs 12-14).

27. The IASB and the US FASB are currently undertaking a joint project to develop a common conceptual framework that both Boards can use in developing new and revised accounting standards, but – for the time being – the objective remains as set out in paragraph 26 above.

28. Both the IASB and ASB frameworks make clear that financial statements are useful to a wide range of users, including present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies, and the public. Both frameworks also make clear that while not all of the information needs of all these users can be met by financial statements, there are needs which are common to all users. As investors (both present and potential) are providers of risk capital to an entity, they are deemed to be the primary users. The provision of financial statements that meet investors’ needs in terms of reporting an entity’s financial performance and financial position will also meet most of the needs of other users that financial statements can satisfy.

Financial reporting and regulatory reporting

29. Whilst financial reporting seeks to satisfy needs which are common to all users, as stated above in paragraph 28 this does not mean that the information will satisfy all of their requirements. In particular, prudential regulators of financial businesses are typically provided with more detailed information than is made available in public reports. Prudential regulators also establish their own techniques for measuring the adequacy of capital held by banks and other financial institutions.

30. Generally, these prudential capital adequacy calculations start with information based on the audited accounts and are then adjusted to meet specific regulatory requirements or objectives. For example, accounting capital is reduced in order to arrive at regulatory capital by deducting goodwill and a prudent bias to valuing assets, but increased by adding back market value losses on available for sale securities. They may, for instance, relate required regulatory capital to assets risk-weighted in various ways (as in the UK) or to overall liabilities through a gearing ratio (as in some other jurisdictions). Financial regulators may also establish different requirements in relation to different categories of capital.

The role of accounting standards

31. Accounting standards provide the essential foundations of effective financial reporting by setting out the requirements for the provision of high quality, transparent and comparable information in financial reports which helps users assess the stewardship of an entity's management and to make economic decisions. Accounting standards should emphasise principles and allow for the exercise of judgment in the way that they are applied, rather than set out detailed rules. This acknowledges that there can be a variety of potentially acceptable accounting methods and choices sometimes have to be made as to which best portrays economic reality.

32. Accounting standards can also be used as a mechanism to improve financial reporting practices. For example, in the UK, a number of the ASB's earlier standards were developed against the background of the corporate scandals of the 1980s, targeting practices previously considered to represent abuses. Significant examples include:

- FRS 4 'Capital Instruments' – designed to prevent corporate debt being characterised as equity;
- FRS 5 'Reporting the Substance of Transactions' – which focused on ensuring that operational assets and related finance are shown on the balance sheet and on curbing early revenue recognition;
- FRS 7 'Fair Values in Acquisition Accounting' and FRS 12 'Provisions, Contingent Liabilities and Contingent Assets' – designed to curtail the shifting of profits from one period to another; and
- FRS 8 'Related Party Disclosures' – designed to highlight when the requisite conditions for competitive, free market dealings between an entity and external parties may not be present due to the existence of related party relationships.

33. In the UK (and wider EU) context, accounting standards are applicable to financial statements of a reporting entity (not just companies) that are intended to give a true and fair view. The ASB's 'Foreword to Accounting Standards', issued in 1993, explains the authority, scope and application of

accounting standards and makes clear that, as accounting standards are authoritative statements of how particular types of transactions and other events should be reflected in financial statements, compliance with them will normally be necessary for those statements to give a true and fair view.

34. The appendix to the 'Foreword' contains a written opinion from Counsel (dated 1993, updating earlier opinions from 1983 and 1984) on the meaning of 'true and fair', with particular reference to the role of accounting standards. Following the enactment of the Companies Act 2006 and the introduction of IFRS referred to in paragraph 16 above, the FRC published in May 2008 a further Counsel's Opinion by Martin Moore QC that confirms the continued relevance of the 'true and fair' concept to the preparation and audit of financial statements. The true and fair requirement therefore remains central to the preparation of financial statements in the UK, whether they are prepared in accordance with UK accounting standards or IFRS. The text of Martin Moore's Opinion as well as an FRC statement on the Opinion can be found on the FRC's website at www.frc.org.uk/about/trueandfair.cfm.

The role of narrative reporting

35. There has for some considerable time been a recognition that financial statements do not meet all the information needs of users and that there is a need for the provision of other information to shareholders giving details of a company's performance and prospects. This was, for example, a conclusion of the report published as early as 1992 by the Committee on the Financial Aspects of Corporate Governance ('the Cadbury Committee').

36. The ASB first issued a Statement on the 'Operating and Financial Review (OFR)' in July 1993. The Statement built on the foundations of existing best practice by providing a framework within which directors could discuss the main factors underlying the company's performance and financial position. The Statement was updated and a revised version issued in January 2003 to reflect later improvements in narrative reporting, and further updated as a Reporting Statement in January 2006.

37. The OFR was, for a brief period during 2005, a statutory requirement for quoted companies. The current statutory requirements are contained in the Business Review provisions of the Companies Act 2006, which fulfil the requirements both of the 2003 EU Accounts Modernisation Directive and, for quoted companies, many of the provisions of the former statutory OFR. These provisions apply for financial years beginning on or after 1 October 2007.

38. The FRC continues to believe that the publication of a narrative explanation of a company's development, performance, position and prospects should continue to be encouraged as an important element of best practice. The ASB's Reporting Statement gives companies clear guidance and

a framework within which they can achieve open and transparent communication with users.

39. The FRC view is that, in the current market situation, the provision of such an explanation becomes even more important. In particular, as highlighted in the FRRP's latest Annual Review (issued on 2 October), the required disclosure of principal risks and uncertainties is likely to warrant greater attention during the forthcoming reporting season. The extent and speed of change in market conditions as a result of the financial crisis affecting banks and, more recently, other sectors of the economy, together with unprecedented fluctuation in some commodity prices means that all companies are facing increased, and possibly different, risks when compared to prior years. Experience has shown that a risk to a company's business model cannot be disregarded on the grounds that its materialisation would require a fundamental change in the market in which a company operates.

The role of fair value accounting in the banking crisis and whether any changes are required

40. Measurement is a critical aspect of financial reporting. For many years historical cost has been used as the basis for measuring assets and liabilities, although it has been modified in various ways – for example, in the United Kingdom, properties have frequently been revalued.

41. Increasingly, however, historical cost is being supplanted in accounting practice as recent accounting standards frequently permit or require measurement at a current value, ie a value that seeks to reflect economic conditions prevailing at the balance sheet date, which includes 'fair value'. This has resulted in a mixed measurement system being used in financial statements.

42. In the current financial crisis, much of the concern has focused on the measurement of financial instruments at fair value, in particular in the financial statements of banks.

What is fair value and why is it used in financial statements?

43. In accounting terms, the IASB defines the fair value of a financial instrument in International Accounting Standard (IAS) 39 'Financial Instruments: Recognition and Measurement'. IAS 39 paragraph 9 defines fair value as "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction". The equivalent UK standard, Financial Reporting Standard (FRS) 26, which is converged with IAS 39, uses the same definition. IAS 39 also requires that all financial instruments are initially recognised in the

balance sheet at fair value and that certain categories would be measured at fair value when being re-measured at subsequent balance sheet dates³.

44. In this context, the objective of fair value accounting is to obtain a market value which is to be used for initial recognition of financial instruments and for subsequent measurement of financial instruments recognised at previous balance sheet dates. The use of fair values is designed to ensure that all companies holding financial instruments use a current valuation for these in their financial reports. This requirement applies in particular to derivatives, financial instruments held by companies for trading purposes or held for sale in the future.

45. IAS 39 requires that derivatives be recognised and measured at fair value as they are typically issued for relatively small initial prices, or even at zero, but they may have a very significant value subsequently and at settlement. Applying a cost approach to their measurement would not reveal that potential impact. Measuring derivatives at fair value ensures that investors are aware of the potential impact on settlement for the company.

46. For financial instruments categorised as being available for sale in the near future it is appropriate that the investors are made aware of the potential value the company can achieve if it sells these assets on or after the balance sheet date.

47. Further detail on the accounting for financial instruments under IFRS and UK GAAP is provided in Appendix B to this paper. This appendix also includes discussion of the accounting requirements relating to impairment of financial instruments.

Fair value reflects the economics of the underlying transactions

48. As noted in the May 2008 report of the IOSCO Technical Committee Task Force on the Sub-prime Crisis, for trading desks, “the importance of daily mark-to-market valuation is fundamental, and position and portfolio values change constantly. Derivative assets can quickly become liabilities and vice versa. With a continuous valuation and revaluation of a portfolio, a trader and firm know whether they make or lose money and then act accordingly (for instance, by increasing a position, unwinding a trade or creating a hedge). Mark-to-market valuation also informs counterparty credit risk exposures and supports margining processes. The alternatives to daily mark-to-market valuation (e.g., using historical cost accounting) are frequently insufficient because they do not provide real-time, actionable feedback upon which traders and senior managers can rely.” When preparing financial reports it is therefore important that the investors are also made aware of the current valuation of such volatile instruments.

³ This is also referred to as fair value accounting or mark-to-market accounting.

49. In its November 2007 submission to the Committee's inquiry into Financial Stability and Transparency⁴, the British Bankers' Association (BBA) acknowledged (paragraph 51) that "fair value measurement provides an appropriate basis for financial instruments held for trading purposes or otherwise managed on a fair value basis".

Use of valuation techniques

50. To help preparers determine the best estimate of fair value under certain market conditions IAS 39 provides a valuation hierarchy. In accordance with this valuation hierarchy, quoted prices in active markets provide the best evidence of fair value and must be used when available. If quoted prices are not available IAS 39 requires companies to use valuation techniques to arrive at an estimate of the fair value.

51. Banks routinely use models to value their products. A large sophisticated bank may use thousands of models to value derivatives and other complex financial instruments and to report on the values of such instruments to management and investors.

52. The purpose of using a valuation technique as an alternative to quoted prices is to calculate what the transaction price would have been on the measurement date in an arm's length exchange promoted by normal business considerations. The technique selected makes maximum use of market inputs, relies as little as possible on entity-specific inputs and is consistent with accepted methodologies for pricing financial instruments.

53. In most cases companies will have concluded whether an active market exists for an asset prior to recent market developments. At each balance sheet date companies will reassess whether an active market still exists for the financial assets they carry at fair value. If the assessment is that an active market does not exist, then as a result certain financial instruments for which quoted prices were previously available will now have to be valued using valuation techniques. Companies are currently required to disclose whether fair values are based on published price quotations or are estimated using a valuation technique. Companies will be required to justify a transition from one level of the hierarchy (quoted prices) to another (valuation technique) in their financial statement disclosures.

54. Volatility and uncertainty in the markets make fair values sensitive not only to the timing of measurement, but also to the data inputs commonly used in valuation models. There are also issues as to which data inputs can be considered observable for the purposes of assessing fair value under IAS 39. The fact that the inputs to the model may have become more volatile and/or

⁴ BBA Memorandum dated 12 November 2007, available at: <http://www.bba.org.uk/bba/jsp/polopoly.jsp?d=155&a=11438>.

scarce is price-relevant information in itself. If the range of plausible values has become wider, then this should be explained to the users rather than pitching for a 'more reliable' alternative such as 'economic' or 'fundamental' values. Where valuation techniques have been used which do not rely on input from market data, this is disclosed and companies are also required to provide details about the assumptions used in the models and the sensitivity of fair values to changes in those assumptions. These are potentially significant issues where judgments have to be made by accountants, auditors and investors.

Fair value provides accurate, timely and comparable information to investors

55. The FRC agrees with those⁵ who argue that, for a range of financial instruments, fair value accounting provides more accurate, timely and comparable information to investors than amounts that would be reported under other alternative accounting approaches (such as using economic, fundamental, average or historic values). Even in the current market conditions, a number of major investors have indicated that they believe that fair value accounting is appropriate and that companies are providing information useful to them. Investors state that the transparency provided by fair value has helped to disclose the true economic position earlier. Moving away from fair value to any of the suggested alternatives is unlikely to increase confidence in the numbers being reported. It will more likely decrease investor confidence in the truth and fairness of the information being provided. From an investor's perspective it is far better if management disclose the information and try to explain how it should be interpreted, rather than try to persuade investors that the problem does not exist. In a global market not providing fair value information and so requiring investors to make an intelligent guess is not a sustainable position.

The role played by fair value in the banking crisis

56. In the current market conditions, the application of fair value accounting has led to the banks in particular reporting losses earlier than any other accounting bases. This has had the benefit of focusing attention much earlier on the banks' business models and facilitated remedial action, such as capital raising, much sooner than would otherwise have been the case.

57. The FRC does not believe that financial reporting, in particular fair value accounting for financial instruments, has caused the current market turmoil, as some have claimed. The FRC believes that the use of fair value accounting is appropriate for a range of financial instruments, particularly

⁵ For example, in the USA, the Center for Audit Quality, the CFA Institute, the Council of Institutional Investors and the Consumer Federation of America, who wrote a joint letter against any suspension of fair value accounting to SEC Chairman Cox on 15 October 2008.

those that are traded in active markets or otherwise managed on a fair value basis.

58. That said, the FRC does acknowledge that there is a need to review the existing requirements in the light of the experience of the current market turmoil, and in view of the concerns that have been raised, to see if any improvements can be made. As is mentioned in paragraph 70 below, the IASB is carrying out a review of the requirements in IFRS for fair value measurements, and the FRC supports, and is contributing to, that work.

Concerns about fair value

59. There are those who argue that fair value accounting has exacerbated the crisis. The arguments of those holding this view were summarised well in the International Monetary Fund's (IMF's) April 2008 Global Financial Stability Report⁶. The IMF Executive Directors generally agreed that the move toward fair value accounting for many types of financial instruments would continue, despite the apparent difficulties in implementing such valuations during the current crisis, since fair value accounting gives the most comprehensive picture of a firm's financial health.

60. However, the report went on to note that it is recognised that investment decision rules based on fair value accounting outcomes could lead to what is termed pro-cyclicality, i.e. the self-fulfilling forced sales and falling prices when valuations fell below important thresholds (either self imposed by financial institutions or by regulation). The report further goes on to note that supervisors would need to play a larger role in judging the reliability of various valuation methods, especially for illiquid or hard-to-value securities, and the IMF's view that accounting standard setters would, in the future, need to consider how accounting practices affect financial stability.

61. Another common objection to fair value accounting is the argument that it increases the volatility of reported results. Inevitably, any accounting approach that reflects price changes will tend to produce more volatile reported results than one that does not. However, if the measurement basis is sound, that volatility should correspond to economic reality.

62. Some have questioned whether recognition of mark-to-market losses is appropriate, noting that in recent months, market values have been significantly lower than some market participant views on what would be a logical 'economic' value when looking at expected default rates across the market as a whole. It is not practical to isolate and measure the amounts attributed to individual effects but they are likely to include:

⁶ IMF (April 2008) 'Containing Systemic Risks and Restoring Financial Soundness'.

- Information asymmetry arising from the difference between an individual investment in a complex structure compared to market data about the market in its entirety
- Behavioural effects such as the potential for reputational damage in the event that it becomes known that the entity has material holdings of illiquid assets
- Concern that intermediaries in the chain between the investor and the ultimate exposure may themselves run into difficulties and default.

63. Historically, the sum of these effects has been small and may not have been material. But recent market conditions have meant that each of these elements has become significant in their own right. Greater understanding of these effects needs to be developed in order to consider whether there is an alternative to the current definition of fair value that would be relevant.

64. All the preceding discussion makes clear that providing current value information is key to ensuring that investors are well-informed. The Japanese experience during the 1990s is a case in point where banks were allowed to hide accounting losses (by reporting historical costs which did not reflect the market values of financial assets held) and present a picture of apparent health to the investors. However, it was common knowledge in the markets that bank balance sheets were far from robust and there was a lack of trust in the figures reported. It can be argued that the recovery would have been far swifter if losses had been acknowledged.

Whether a change to fair value accounting standards is appropriate

FSF recommendations

65. The April 2008 report of the Financial Stability Forum (FSF) 'Enhancing Market and Institutional Resilience' called for international standard setters to enhance accounting, disclosure and audit guidance for valuations. To address these issues, the FSF noted that:

- the IASB will strengthen its standards to achieve better disclosures about valuations, methodologies and the uncertainty associated with valuations; and
- the IASB will enhance its guidance on valuing financial instruments when markets are no longer active. To this end, it will set up an expert advisory panel in 2008.

IASB response to-date

66. There have been many calls for changes to be made to IAS 39. The FRC believes that, while there are issues that need to be considered on whether the accounting standards can be improved, any potential amendments should be

considered by the IASB, preferably in co-ordination with the FASB to promote a level playing field between IFRS and US GAAP, with appropriate due process, in order to allow for a full assessment of the technical and practical issues and to avoid any unintended consequences.

67. The IASB has already made changes to the IAS 39 requirements on the reclassification of financial instruments (issued on 13 October 2008). This change had the impact of relaxing rules that prohibited any movements out of the held for trading and held for resale categories. The effect is that gains and losses arising due to changes in fair value on instruments that are reclassified will not be reported in the profit and loss account after the reclassification. This change was approved by the EU Accounting Regulatory Committee (ARC) on 15 October and adopted into EU law as Regulation 1004/2008 on the same day. The amendment is applicable from 1 July 2008.

68. Consistent with the FSF recommendations (paragraph 66 above), the IASB's expert advisory panel was set up in May 2008 specifically to consider the application of fair value when markets become inactive and provide guidance for constituents on this issue. The draft report of the EAP was exposed in August 2008 for constituent comments. The final report was published on 31 October 2008.

69. On 20 October, the IASB and FASB announced further details on their joint approach to dealing with financial reporting issues arising from the global financial crisis. The two Boards emphasised the role of high quality financial reporting in helping enhance confidence in the financial markets by responding in a timely manner that improves transparency and provides greater global consistency in financial reporting. In doing so, the two Boards have agreed to take a number of measures including:

- setting-up of a high-level advisory group tasked with considering how improvements in financial reporting could help enhance investor confidence in financial markets, and identifying the accounting issues requiring urgent and immediate attention of the two boards, as well as issues for longer-term consideration;
- holding public round tables in Asia, Europe and North America. The purpose of these public roundtables is to gather input on reporting issues emanating from the current global financial crisis – including responses by governments, regulators and others; and
- developing common solutions aimed at providing greater transparency and reduced complexity in the accounting for financial instruments. The boards will use their joint discussion paper 'Reducing Complexity in Reporting Financial Instruments', the responses received to the discussion paper, and the

deliberations of the high-level advisory group as starting points for this longer term objective.

70. The IASB is also undertaking a standard-by-standard review of fair value measurements currently required or permitted under IFRS to develop greater clarity in the interpretation of 'fair value'. This review will address issues such as whether fair value should be represented by a current exit (or selling) price, and whether it is appropriate for the fair value for liabilities to be affected by the reporting entity's own credit risk.

Pressure from Europe

71. Subsequent to the IASB publication of the amendment to IAS 39 on 13 October 2008, the European Commission (EC) convened a meeting of stakeholders to consider any other European issues that need urgent consideration by the IASB. Following this stakeholder meeting, the EC sent a letter to the IASB dated 27 October 2008 requesting further amendments to IAS 39 by the end of December 2008. These include urgent requests for:

- a. permitting reclassification of financial instruments that are not required to be measured at fair value but which the banks voluntarily opted to designate at fair value (the so-called fair value option). Redesignation out of fair value is currently prohibited in IAS 39);
- b. a clarification of whether the standards require derivatives embedded in synthetic Collateralised Debt Obligations (CDOs) to be accounted for separately at fair value; and
- c. a change in requirements for the impairment of available for sale (AFS) financial assets.

72. The FRC believes that while there are issues that need to be considered on whether the relevant accounting standards can be improved, any potential amendments should be considered by the IASB, preferably in co-ordination with the FASB to promote a level playing field between IFRS and US GAAP. The amendments should be considered, with appropriate due process, in order to allow for a full assessment of the technical and practical issues and to avoid any unintended consequences. The FRC does not believe that any of the above issues are of such urgency that any potential changes to standards need to be made before the end of 2008.

The role and accountability of the IASB

73. The IASB is the standard-setting body of the International Accounting Standards Committee Foundation (IASC Foundation), an independent, not-for-profit organisation, which was incorporated in February 2001. The IASC Foundation and the IASB succeeded a predecessor organisation, the

International Accounting Standards Committee (IASC), and their establishment was designed to increase the standard-setter's independence.

Role of the IASB

74. The IASC Foundation is governed by its Constitution, which was first approved in 2000, with a revised and updated version published in 2005, following a major review by the IASC Foundation Trustees. The objectives of the IASC Foundation, as set out in its Constitution, are:

- a. to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions;
- b. to promote the use and rigorous application of those standards;
- c. in fulfilling the objectives associated with (a) and (b), to take account of, as appropriate, the special needs of small and medium-sized entities and emerging economies; and
- d. to bring about convergence of national accounting standards and International Accounting Standards and International Financial Reporting Standards to high quality solutions.

75. As the standard-setting body of the IASC Foundation, the IASB's foremost objective is that set out in paragraph 74(a) above. While the IASB has no power to force any jurisdiction to adopt its standards, it is a testament to its success that more than 100 countries now require or permit the use of IFRS or are converging with IFRS.

76. The FRC supports the work that the IASB has undertaken towards achieving the vision of a single set of global standards. That does not mean that the FRC agrees with every proposal the IASB makes, but whatever the conflicting views on certain aspects of certain standards, the over-riding benefits of having global standards have not changed. They include comparability of company performance across borders, reduced compliance costs and the abolition of reconciliations to different national accounting frameworks for companies that report in more than one jurisdiction. Since business fundamentals are the same across the world, it makes little sense in the long run to have different standards in different parts of the world. But the FRC is also firmly of the view that any single suite of global standards needs to be of high quality and ensure adequate and relevant disclosure to protect markets from abuse and to promote fair, orderly and efficient markets.

Accountability

77. The aim of the IASC Foundation structure is designed to support those features that are regarded as desirable in establishing the legitimacy of a standard-setting organisation. These include:

- a standard-setting body, the IASB, which consists of members who are technically expert, represent the wider business community and are independent; and
- a Board that is accountable to the Trustees, governed by a Constitution which is publicly available.

78. The Constitution requires the Trustees to review the Constitution every 5 years and to undertake a public consultation. The Trustees' second review of the Constitution is now underway.

79. That said, there have been concerns expressed for a number of years about the legitimacy of the IASC Foundation and its public accountability. In recognition of those concerns, the Trustees – as part of the current Constitution Review – have proposed to establish a formal link to public institutions with the setting up of a 'Monitoring Group' (MG) consisting of representatives of supervisory and international organisations, notably securities regulators. The establishment of the MG would provide a public accountability link between the Trustees and representatives of official institutions. This proposal was included in a consultation document 'Review of the Constitution: Public Accountability and the Composition of the IASB – Proposals for Change', issued by the IASC Foundation in July 2008.

80. The FRC response to the consultation, submitted on 16 September 2008, welcomed the creation of such a link. The FRC believes, however, that it is important that the rationale for membership of the MG is clearly articulated. The FRC also believes that the mandate of the MG needs to be made very clear. In our view, it is important that the Trustees remain the body primarily responsible for the governance of the IASC Foundation and the oversight of the IASB.

The processes for developing and/or amending accounting standards

81. The IASC Foundation Constitution (paragraph 31) sets out the procedures that the IASB shall follow in the preparation and issue of IAS, IFRS and Exposure Drafts. Paragraph 31(b) in particular states that the IASB shall "publish an Exposure Draft on all projects and normally publish a discussion document for public comment on major projects"

82. The procedures outlined in the Constitution are articulated more fully in the 'Handbook of Consultative Arrangements (Due Process Handbook) for

the IASB', which was approved by the Foundation Trustees in March 2006 (<http://www.iasb.org/About+Us/How+we+develop+standards/How+we+develop+standards.htm>). The Due Process Handbook was itself subject to two rounds of public consultation, review by the Standards Advisory Council, and public debate by the Trustees.

83. The Due Process Handbook emphasises three important requirements:

- transparency and accessibility;
- extensive consultation and responsiveness; and
- accountability.

84. The IASC Foundation 'Annual Report 2007' also notes that the IASB is taking further steps to enhance its due process and interaction with interested parties, with:

- the introduction of feedback statements and impact assessments; and
- an agreement to conduct post-implementation reviews of all new IFRS, major amendments to IFRS and major IFRIC Interpretations two years after their implementation.

85. The FRC supports the due process procedures put in place by the IASC Foundation and – as noted in paragraph 25 above – believes that the most appropriate standards are developed by standard setters who are able to exercise independent judgment, supported by effective consultation with market participants and other stakeholders. That has been the position in the UK since 1990 and the FRC believes it is equally appropriate for the development of standards for use globally.

86. The FRC notes that the IASC, with the agreement of the IASC Foundation Trustees, suspended its normal due process in issuing amendments to IAS 39 and IFRS 7 'Reclassification of Financial Assets' on 13 October 2008. The FRC supports the decisions taken by the IASC Foundation Trustees and the IASB on this issue, but in order to address the rare circumstances of the current credit crisis, we would be concerned if this created a precedent for the wider avoidance and/or curtailment of due process.

87. In order to ensure that entities applying the equivalent UK standards (FRS 26 and FRS 29) have the same ability to make reclassifications as those applying IFRS, the ASB suspended its normal due process and issued similar amendments on 24 October 2008. The ASB normally applies due processes that entail one or two rounds of public consultation. These are set out in paragraphs 23-26 of the ASB's 'Foreword to Accounting Standards', which can be accessed at: <http://www.frc.org.uk/asb/technical/foreword.cfm>.

The purpose, and intended audience of, a statutory audit

88. Public confidence in the operation of the capital markets and in the conduct of public interest entities depends, in part, on the credibility of the opinions and reports issued by the auditor in connection with the audit of financial statements.

89. The primary purpose of an audit of the financial statements is for the auditor to provide independent assurance to the shareholders that the directors have prepared the financial statements properly. As required by legislation, the auditor issues an opinion as to whether or not the financial statements give a true and fair view.

90. The APB establishes quality control, auditing and ethical standards for auditors to provide a framework for audit practice in the UK and the Republic of Ireland. The APB made the strategic decision in 2004 to base its auditing standards on International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board (IAASB). It issued a new set of auditing standards (known as ISAs (UK and Ireland)) in December 2004 which reflected important improvements in key areas. These areas included identifying, assessing and responding to audit risks, including fraud risks, and quality control procedures for audits. The APB is currently consulting on when and how to update its standards to reflect a major improvement project, known as the "Clarity Project", soon to be completed by the IAASB. As part of the Clarity Project, ISAs on important topics such as accounting estimates, including fair value measurements and disclosures, group audits and related party transactions have been improved to reflect the latest developments and thinking. The APB has stated that, as the improvements made are designed to enhance audit quality, it believes there is merit in introducing these new standards in the UK and Ireland as soon as is practicable.

91. The APB also issues guidance in the form of Practice Notes and Bulletins to assist auditors in applying its standards to particular circumstances and industries and to address new or emerging issues. For example, a revised Practice Note on the audit of banks and building societies in the UK was issued in January 2007 and a Bulletin dealing with matters to be considered by auditors in the light of recent developments in financial markets was issued in January 2008.

92. The Audit Inspection Unit (AIU), part of the Professional Oversight Board, is responsible for the monitoring of the audits of all listed and other major public interest entities. The audits of all UK incorporated companies with listed securities (both equity and non-equity securities) and other entities in whose financial condition there is considered to be a major public interest are within the scope of the AIU's work. A description of the entities within the

AIU's scope for 2008/9 was issued in March 2008. The monitoring units of the professional bodies are responsible for the monitoring of other audits within the scope of audit regulation in the UK (i.e. those outside the scope of independent inspection by the AIU). In addition to the Big 4 Firms, there are currently five other major firms undertaking more than ten audits within the AIU's scope and therefore subject to full scope AIU inspections, including a review of their firm-wide procedures, under statute. Other firms which have any audits falling within the AIU's scope are subject to periodic reviews of one or more such audits by the AIU and reviews of their firm-wide procedures by the monitoring unit of the professional body with which they are registered.

93. UK law requires that the auditors of listed and other major public interest entities are monitored at least once every three years. However given their significance the AIU currently inspects the largest six audit firms in the UK every year.

94. In the year to 31 March 2008 the AIU conducted seven full scope inspections of large audit firms and reviewed 90 individual audits of major public interest entities. Some 25% of those audits were of entities in the Banking, Finance and Investment industry sector.

95. The AIU made a number of changes for its 2008/9 inspection cycle to respond to the heightened audit risk posed by the credit market turbulence. It had earlier met with each of the largest firms to discuss how they were responding to the heightened risk both at a firm-wide level and in planning and executing individual audits. These changes included:

- Adopting a more risk-based approach in selecting individual audits for reviews and prioritising reviews within the 2008/9 cycle.
- Reviewing and updating the work programmes used for reviews of individual audits to ensure that risk areas relating to the credit market turbulence were covered in all cases.
- Undertaking some reviews focused specifically on issues relating to the credit market turbulence

96. The AIU will undertake a similar review for 2009/10, in conjunction with the POB, with a view to responding appropriately to the audit risks arising from recent developments in financial markets.

97. In 2007 the POB consulted on a new approach to reporting by the AIU. The results of that consultation were published on 4 December 2007 in a document called 'Reporting on Audit Quality Monitoring - Implementing a New Approach'.

98. A key change to the reporting was that the AIU would no longer publish one annual report on generic themes and findings but rather that they would replace this by high level public reports on individual audit firms. Such reports would only be published for those firms where the AIU had undertaken a full scope inspection. The content of these reports would be based on the findings as set out in the private reports to the respective audit registration committees. The first such reports will be issued in December.

99. Another significant change in reporting was the introduction of new style reports on the individual audits reviewed by the AIU after 1 January 2008. While these reports are addressed to the relevant audit engagement partner, our expectation is that they will be provided to the relevant client's audit committee. This is also another important contribution to the transparency of reporting on the work the UK's audit profession.

**Financial Reporting Council
3 November 2008**

Appendix A

THE FRC AND ITS OPERATING BODIES

A1 The Financial Reporting Council (FRC) is the UK's independent regulator of corporate reporting and governance. Working mainly through the Board's Committee on Corporate Governance and the six operating bodies, the FRC sets standards for corporate governance, reporting, auditing and actuarial practice; monitors and, where appropriate, enforces the application of those standards; and works with the accountancy and actuarial professions to promote the professionalism of their members.

Our aim

A2 Confidence in corporate reporting and governance is a fundamental prerequisite for the effective functioning of the economy and financial markets. The FRC's aim is to strengthen that confidence by promoting high-quality corporate governance, corporate reporting, auditing and actuarial practice, and by promoting the integrity, competence and transparency of the accountancy and actuarial professions.

Our regulatory philosophy

A3 The FRC does not regard regulation as an end in itself. We believe in wealth creation. We believe that our role in promoting confidence in corporate reporting and governance as part of a regulatory framework that promotes enterprise, investment and employment can make the creation of wealth more likely. We are committed to the Better Regulation Commission principles of proportionality, targeting, consistency, transparency and accountability. We are clear that no system of regulation can eliminate the possibility of corporate reporting or governance failures; any attempt to achieve zero failure would destroy wealth rather than facilitate its creation.

The strategic outcomes we seek

A4 The strategic outcomes the FRC seeks are that:

- Companies are led in a way which facilitates entrepreneurial success and the management of risk.
- Corporate reports contain information which is relevant, reliable, understandable and comparable, and are useful for decision-making, including stewardship decisions.
- Users of audit reports can place a high degree of reliance on the audit opinion, including whether financial statements show a true and fair view.

- Users of actuarial information can place a high degree of reliance on its relevance, transparency of assumptions, completeness and comprehensibility.
- Clients and employers of professionally qualified accountants and actuaries and of accountancy and actuarial firms can rely on them to act with integrity and competence, having regard to the public interest.
- The FRC is an effective and independent regulator, actively helping to shape UK, and to influence EU and global, approaches to corporate reporting and governance.

A5 We believe there are strong connections among corporate governance, auditing, actuarial practice, corporate reporting and the professionalism of accountants and actuaries. We believe the breadth of our responsibilities and functions enhances our effectiveness.

Our structure

A6 The decision-making bodies are the Board of FRC Ltd and its operating body boards.

A7 The Board of FRC Ltd is designed to be composed of the Chair, the Deputy-Chair, the Chief Executive, the Chairs of the six operating bodies, and seven non-executive directors. The FRC Chair and Deputy-Chair are appointed by the Secretary of State for Business, Enterprise and Regulatory Reform. All other members are appointed by the Board.

A8 The Board's functions include:

- To determine our strategy and priorities.
- To set our budget, secure the necessary funding and monitor expenditure.
- To oversee the delivery by each operating body of its functions.
- To approve changes to the Combined Code on Corporate Governance.

A9 The Committee on Corporate Governance supports the Board of the FRC in its work on corporate governance. The Committee keeps under review developments in corporate governance generally, reflecting the FRC's objective of fostering high standards. It monitors the Combined Code on Corporate Governance and its implementation by listed companies and shareholders.

The operating bodies

A10 The Accounting Standards Board issues accounting standards for the UK and Ireland but, with the move to International Financial Reporting Standards (IFRS), it is increasingly focussed on influencing the setting of

standards by the International Accounting Standards Board (IASB) on behalf of its stakeholders.

A11 The Auditing Practices Board issues standards and guidance for auditing, for the work of reporting accountants in connection with investment circulars, and for auditors' integrity, objectivity and independence. It is also active in influencing the International Auditing and Assurance Standards Board in setting International Standards on Auditing.

A12 The Board for Actuarial Standards, set up in 2005 following a decision to establish independent oversight of the actuarial profession, sets technical standards for actuarial work.

A13 The Professional Oversight Board provides independent oversight of the regulation of accountants and actuaries by their respective professional bodies. It provides statutory oversight of the regulation of the auditing profession by the recognised supervisory and qualifying bodies, and, through the Audit Inspection Unit, monitors the quality of the auditing function in relation to economically significant entities.

A14 The Financial Reporting Review Panel reviews company accounts for compliance with the law and accounting standards. The Panel reviews the annual accounts of some 300 public and large private companies a year and keeps under review interim and final reports of certain other listed issuers. It is the role of the Panel to enquire into cases where, in the words of the Companies Act, 'it appears to the Panel that there is, or may be, a question whether accounts comply with the requirements of this Act'.

A15 The Accountancy and Actuarial Discipline Board is the independent investigative and disciplinary body for accountants and actuaries in the UK. It is responsible for operating and administering independent disciplinary schemes. The Accountancy Scheme covers Members of the following accountancy professional bodies: the Association of Chartered Certified Accountants, the Chartered Institute of Management Accountants, the Chartered Institute of Public Finance and Accountancy, the Institute of Chartered Accountants in Ireland, the Institute of Chartered Accountants of Scotland and the Institute of Chartered Accountants in England and Wales. The Actuarial Scheme covers Members of the Institute of Actuaries and the Faculty of Actuaries.

History of setting accounting standards in the UK

A16 The operating body of the FRC which has responsibility for accounting standards issues is the ASB, which was set up in 1990 to develop and issue accounting standards, known as Financial Reporting Standards (FRSs). Prior to that date, accounting standards had been set by the accountancy

profession, under the auspices of the Accounting Standards Committee (ASC), which – from 1976 – was constituted as a joint committee of the six member bodies of the Consultative Committee of Accountancy Bodies (CCAB). Any proposals for standards developed by the ASC had to be approved and issued by the Councils of the CCAB members. These were known as Statements of Standard Accounting Practice (SSAPs).

A17 In the wake of several corporate failures, and the increasing complexity and potential for controversy of the issues facing the accountancy profession, the CCAB in 1987 appointed a Review Committee, under the Chairmanship of Sir Ron (now Lord) Dearing to review and make recommendations on the standard-setting process. The Review Committee report ‘The Making of Accounting Standards’ was published in 1988 and recommended a new independent regime of accounting standard-setting. This met with widespread acceptance in business, government and the profession. The ASB, under the oversight of the FRC, replaced the ASC on 1 August 1990.

A18 The ASB was given the authority to issue accounting standards on its own authority. The Companies Act 1989 introduced into the Companies Act 1985 a definition of ‘accounting standards’ along with the requirement for directors of companies, other than most small or medium sized companies, to disclose whether the accounts have been prepared in accordance with applicable accounting standards, particulars of any material departure from those standards and the reasons for the departure. The ASB was originally given recognition as the body prescribed to issue accounting standards by regulations made under Section 256 of the Companies Act 1985 and, subsequently, regulations made under Section 464 of the Companies Act 2006.

A19 The role of the ASB has been impacted by European legislation passed in 2002 (EU Regulation 1606/2002) requiring the consolidated financial statements of companies in the EU whose securities are admitted to trading on a regulated market (publicly traded companies) to comply with international, rather than national, accounting standards for financial years beginning on or after 1 January 2005. The Regulation includes a process for the endorsement of International Financial Reporting Standards (IFRS) for use in the EU (EU-adopted IFRS). The UK Government has taken up a Member State option in the Regulation which permits the annual accounts of publicly traded companies and the annual and/or consolidated financial statements of other companies (other than charitable companies) to be prepared in accordance with EU-adopted IFRS.

A20 With the advent of 2005, the environment for accounting standard-setting changed dramatically and the role of the ASB has moved away from developing its own standards (although most UK companies continue to apply FRs). Apart from developing a strategy for the future of UK standards and their convergence with IFRS, the ASB’s major activities are focused on:

- seeking to influence the International Accounting Standards Board (IASB) (and US Financial Accounting Standards Board, FASB) on the development of IFRS and a revised conceptual framework. As part of this, the ASB responds to all IASB consultation documents after consultation with constituents and challenges the IASB where we believe that the proposals will not result in improvements in the quality of financial reporting; and
- playing a leading role in Europe, in particular with the European Financial Reporting Advisory Group (EFRAG), both to ensure appropriate European influence in the development of international standards and their adoption in the EU.

Appendix B

ACCOUNTING FOR FINANCIAL INSTRUMENTS UNDER IFRS AND UK GAAP

B1 The financial instruments commonly associated with the current credit crisis include Asset Backed Commercial Papers (ABCP), securitisation loan notes and collateralised debt obligations (CDOs) amongst others. These are categorised as financial instruments, the accounting requirements for which are set out in International Accounting Standard (IAS) 39, which was finalised by the IASB in 1999 and adopted by the EC (with minor modifications) for application by European publicly traded companies in 2004. The accounting requirements relating to the valuation of financial instruments under IFRS and UK GAAP are identical, as the relevant UK standard, FRS 26, is converged fully with IAS 39⁷.

Fair value requirements

B2 IAS 39 (paragraph 43) require all financial assets and liabilities to be recognised at fair value on initial recognition. Fair value is defined in IAS 39 (paragraph 9) as “the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction”. The Application Guidance (AG) of Appendix A to the standard (paragraph AG69) makes clear that underlying the definition of fair value is a presumption that an entity is a going concern without any intention or need to liquidate, to curtail materially the scale of its operations or to undertake a transaction on adverse terms. Fair value is not, therefore, the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale. However, fair value does reflect the credit quality of the instrument.

B3 Certain categories of financial assets (those at fair value through profit or loss and available-for-sale) are required to be measured at fair value on an ongoing basis with any changes to the fair value to be taken through the profit or loss (or equity for available-for-sale assets) (paragraph 46 of IAS 39). Similarly financial liabilities at fair value through profit or loss are required to be measured at fair value on an on-going basis (paragraph 47 of IAS 39).

B4 Fair value measurement considerations and requirements are highlighted in paragraphs 48, 48A and 49 of IAS 39 and in paragraphs AG69-AG82. Paragraph 48A of the standard explains that the existence of quoted prices in an active market is the best evidence of fair value. If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique, with the objective of establishing what the transaction price would have been on the measurement date in an arm’s length exchange

⁷ The rest of this document refers only to IAS 39 requirements. However, there are equivalent requirements in FRS 26 that apply to UK companies that are within the scope of FRS 26, which includes all banks.

motivated by normal business considerations. The standard requires that the chosen valuation technique makes “maximum use of market inputs and relies as little as possible on entity-specific inputs”.

B5 The standard goes on to note that, periodically, an entity calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument (ie without modification or repackaging) or based on any available observable market data. Where there is no active market, paragraph AG78 acknowledges that the same information may not be available at each measurement date to determine whether there have been any changes in conditions since the most recent market transaction that may result in a corresponding change in the fair value of the financial instrument being valued. However, the entity would still be expected to make reasonable efforts to determine whether there is evidence that there has been a change in conditions.

Impact of credit market turbulence on fair value

B6 Investors in ABCP and credit derivatives would be expected to account for these products at fair value in accordance with IAS 39, either through the profit or loss or through equity, depending on how the financial instruments have been categorised. This would mean that the recent turbulence in the credit markets would be reflected in the revaluations of these financial instruments. The requirements under IFRS would be that the fair value of these financial instruments, and not the fire sale value, is presented in the financial statements. So that even with very few trades in the market the reporting entity would need to take the market trades into account when valuing their own products. Assuming, at this point, that the valuations are reliable the advantage of this approach is that any gains or losses of the financial assets and liabilities of the investing entity are clear to their shareholders.

B7 However, there is the issue of reliability of pricing in the credit markets. A number of inputs into the models used to price the products are currently particularly difficult to obtain and most of these had been estimated from previous history which was built up during a period of very low interest rates and benign market conditions. Additionally, there appears to have been limited stress testing of large changes in interest rates on the default rates or consideration of the impact on default rates of other socioeconomic factors. As a result, default rates, which are a key input in the pricing of credit related financial instruments, remain difficult to ascertain in current market conditions. This uncertainty will be reflected in fair value disclosures in the financial statements of the investors. However, as noted above the entities will still be required to make every effort to ascertain the fair value of these products in accordance with IAS 39.

Measurement of default rates and correlation risk

B8 One of the main initiators of the credit crunch was the higher-than-expected default rates on the US sub-prime market. Default rates are one of the main components of the value of credit derivative trades (where such mortgages were used as the underlying assets) and are normally based on historical data. The actual default rates have turned out to be far higher than suggested by this data and as a result once the new fair values are calibrated large swathes of first default notes have either been depleted beyond repair or have been completely wiped out. This will impact future fair values of financial instruments linked directly or indirectly to credit risk.

B9 For structured credit financial products based on underlying asset portfolios of mortgages, credit card receivables and unsecured loans correlation is a key risk. Default correlation risk is the increase in probability of default of an asset arising from the default of a different asset that is included in the asset portfolio. Default correlation risk has been changing significantly as a result of the events of the past few months and is likely to be different to that predicted at inception of many of these transactions. This will impact the pricing of the underlying assets in the Structured Investment Vehicles (SIVs) that holds the receivables as well as the loan notes/ABCPs it issues. The fair values of such investments are likely to be volatile for the near future, and as a result the financial statements presented in accordance with IFRS are likely to reflect such volatility.

Impact of deterioration in a bank's credit risk

B10 The fair value measurement requirements in IAS 39 have the effect that the instrument's credit characteristics impact its valuation. The effect of this is most pronounced in the valuation of liabilities where deterioration in the credit quality of a bank leads to a decline in the value of that bank's liability – a result that many consider counter-intuitive.

B11 FRS 26 applies the same rules as IAS 39 and US GAAP to the valuation of liabilities – where these are fair valued, the credit risk of the instrument is taken into account in determining the fair value, so that a deterioration in the credit rating of the instrument will result in a lower fair value and a gain to the issuing entity that is reported in profit. (The IASB's reasoning for adopting this approach is set out in the Basis for Conclusions of IAS 39, paragraphs BC 87 to BC 92 – which are reproduced in FRS 26.)

B12 However, entities applying FRS 26 or IAS 39 normally account for long term loans at amortised cost. These loans are only accounted for at fair value if the entity chooses the fair value option in respect of the borrowings. The fair value option is only available if either (a) fair valuing the liability is necessary to avoid an accounting mismatch (ie if the liability is funding assets that are themselves fair valued); or (b) the borrowings are in a portfolio that is

managed on a fair value basis. Generally, we would expect a number of counterparties dealing in the products described above, to have decided to manage the loans on a fair value basis and therefore meet the second criterion.

Impairment of financial assets

B13 As a result of the current uncertainty in the credit markets and uncertainty in general market conditions it is likely that companies notice significant impairments of financial assets categorised as available-for-sale, held at cost or amortised cost. As is explained in more detail below, impairment of these assets is reported as a loss in the profit and loss account.

B14 IAS 39 requires entities to look for objective evidence when assessing whether a financial asset or group of financial assets is impaired. IAS 39 paragraph 59 states that the objective evidence of impairment is likely to result from "one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. It may not be possible to identify a single, discrete event that caused the impairment." Therefore, a single event such as the disappearance of an active market or a credit downgrade by the ratings agency is not sufficient evidence on its own to lead to an impairment loss being recognised. These need to be considered together with other available information.

B15 IAS 39 paragraph 59 goes on to set out a number of loss events that provide objective evidence of impairment of a financial asset. These include:

- (a) "significant financial difficulty of the issuer or obligor;
- (b) a breach of contract, such as a default or delinquency in interest or principal payments;
- (c) the lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider;
- (d) it becoming probable that the borrower will enter bankruptcy or other financial reorganisation;
- (e) the disappearance of an active market for that financial asset because of financial difficulties; or
- (f) observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including:
 - (i) adverse changes in the payment status of borrowers in the group (eg an increased number of delayed payments or an increased number of credit card borrowers who have reached

their credit limit and are paying the minimum monthly amount);
or

- (ii) national or local economic conditions that correlate with defaults on the assets in the group (eg an increase in the unemployment rate in the geographical area of the borrowers, a decrease in property prices for mortgages in the relevant area, a decrease in oil prices for loan assets to oil producers, or adverse changes in industry conditions that affect the borrowers in the group)."

B16 It is obvious from the above list that the standard would only consider an observable significant event or prolonged decline in the value of the financial asset below cost to be sufficient evidence of impairment. It is therefore important that companies ensure such observable evidence exists when considering whether financial assets they hold are impaired.

B17 Treatment of impaired financial assets varies under IAS 39 depending on whether they are classified as available-for-sale or carried at cost or amortised cost. The treatment is discussed separately below.

Available-for-sale financial assets

B18 IAS 39 requires that any fair value changes in available-for-sale financial assets are recognised directly in equity. If objective evidence exists that such an asset is impaired then IAS 39 paragraph 67 requires that "the cumulative loss that had been recognised directly in equity shall be removed from equity and recognised in profit or loss even though the financial asset has not been derecognised."

B19 In the event that the impairment losses are reversed in subsequent periods IAS 39 only allows the reversal of the loss in relation to a debt instrument to be recognised in the profit or loss. However, such a reversal for an equity instrument is not permitted.

Financial assets carried at amortised cost

B20 IAS 39 permits held-to-maturity investments and loans and receivables to be carried at amortised cost. If there is objective evidence that an impairment loss has been incurred on such assets IAS 39 requires the entity to reduce the carrying amount of the asset, either directly or through a loan allowance, and recognise the amount of the loss in the profit or loss.

B21 The impairment loss of a financial asset carried at amortised cost is measured using the financial instrument's original effective interest rates. The reason for this approach is that using the current market rate of interest for the purposes of the calculation of loss would be the same as imposing fair value measurement on financial assets that are otherwise carried at amortised cost. If a range of possible loss amounts exists IAS 39 states that "the entity

recognises an impairment loss equal to the best estimate within the range taking into account all relevant information available before the financial statements are issued about conditions existing at the balance sheet date”.

B22 In the event of a subsequent reversal of the impairment loss IAS 39 permits the recognition of the reversal either directly in the carrying amount of the asset or by adjusting the allowance account and in the profit or loss. However, IAS 39 paragraph 65 specifies that the reversal should not “result in a carrying amount of the financial asset that exceeds what the amortised cost would have been had the impairment not been recognised at the date the impairment is reversed”.

Financial assets carried at cost

B23 IAS 39 requires recognition of an impairment loss on assets carried at cost. IAS 39 paragraph 66 sets out how such impairment losses are calculated. It states that:

“If there is objective evidence that an impairment loss has been incurred on an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured, or on a derivative asset that is linked to and must be settled by delivery of such an unquoted equity instrument, the amount of the impairment loss is measured as the difference between the carrying amount of the financial asset and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset” [text not italicised in IAS 39].

B24 IAS 39 does not permit such impairment losses to be reversed.