Fédération des
Experts Comptables
Européens

FEE Position

Call for Global Standards: IFRS

FEE calls on all parties in the financial reporting chain to come to reasonable solutions in a cooperative manner in order to ensure that a global set of standards on financial instruments is endorsed (or at least the endorsement decision is made public) in 2004, recognising that IASB is committed to further improving the standards.

As a general principle, FEE supports global standards and therefore emphasises the need for 'endorsed IFRS' to be the same as 'IFRS'. The endorsement process should not be used as a means to create European standards. Only global standards will meet the wider objectives of financial stability, efficiency and transparency and provide the benefits of increasing confidence in financial markets and of facilitating global investments, thereby reducing the cost of capital. There would be serious drawbacks if elements of IFRS were not endorsed: EU standards would be seen as very much a second best.

There are also serious audit reporting implications if 'endorsed IFRS' are different from IFRS: IFRS could no longer be referred to as the reporting framework.

Key Messages:

- FEE is strongly committed to high quality, global, principle-based neutral financial reporting standards.

- High quality financial reporting applying principle-based standards necessarily involves judgement and integrity in its application.

- Each of the players in the financial reporting chain must assume its responsibilities and behave in an ethical manner.

- Convergence must involve seeking the best principle-based solutions and should demonstrate fully that experience from across the globe has been utilised.

- If endorsement of standards published by IASB takes a long time, it will create major uncertainties for preparers that have committed themselves to have IFRS in place by 2005, as well as for users and auditors.

- There are serious implications if non-endorsement results in a European standard in one or more areas:

  - Extra disclosures to explain differences from IFRS, for reasons of transparency;
  - Companies would no longer be able to claim that their financial statements were prepared under IFRS, with related consequences for the audit report;
  - Related audit implications;
  - The risk of setting a precedent;
  - System changes implications of any unique European standards in any area, such as IAS 39;
  - The risk that some financial institutions, banks or insurance undertakings that apply or want to apply IAS 39 will be seriously disadvantaged;
  - Access to capital markets could be restricted or made more expensive; and
  - Loss of opportunity to converge IFRS and US GAAP and possible impact on other elements of transatlantic dialogue.

- FEE favours stronger enforcement systems with more powers and resources to enforce accounting standards applied by listed companies and effective coordination between national enforcement bodies.

- FEE calls on all parties to come to reasonable solutions in a cooperative manner in order to have a global standard on financial instruments available for endorsement in 2004, thereby providing Europe with a comprehensive set of IFRS, identical with full IFRS.

Global, Principle-Based Standards are the Best for Europe

FEE is strongly committed to high quality, global, principle-based, neutral financial reporting standards and accordingly supports the IAS Regulation.

The IAS Regulation states in the preamble that:

"In order to contribute to a better functioning of the internal market, publicly traded companies must be required to apply a single set of high quality international accounting standards for the preparation of their consolidated financial statements. Furthermore, it is important that the financial reporting standards applied by Community companies participating in financial markets are accepted internationally and are truly global standards. This implies an increasing convergence of accounting standards currently used internationally with the ultimate objective of achieving a single set of global accounting standards" and

"It is important for the competitiveness of Community capital markets to achieve convergence of the standards used in Europe for preparing financial statements, with international accounting standards that can be used globally, for cross-border transactions or listing anywhere in the world."

Global financial markets require financial information prepared in accordance with global standards for reasons of competitiveness and comparability and for capital raising purposes. A principle-based approach to financial reporting means that clear principles are designed to serve the public interest, accompanied by a limited number of rules that show how those principles should be applied in common situations. Such an approach promotes consistency and transparency and helps companies and their advisers to respond appropriately to complex situations and new developments in business practice. It also prevents the risk of regulatory overload from detailed rules that may be developed in an attempt to cope with all the eventualities that may arise in practice.

A principle-based approach requires both companies and their auditors to exercise professional judgement. The objective of financial statements is to provide a fair presentation of the company's financial position, the results of its operations and its cash flows for the period. This approach emphasises the obligation to prepare financial statements that provide a faithful presentation of all transactions. This approach can be contrasted with one that relies only on a mechanical compliance with codified rules, without considering whether the resulting financial statements give a fair presentation overall.

In its discussion paper on a Financial Reporting Strategy within Europe, dating back to 1999, FEE recommended the use of IAS, indicating a preference for global standards and offering a global solution to standard setting, since Europe could not support a set of standards over which it had no influence (such as US GAAP). In FEE submissions to the SEC and FASB, FEE again supported the principle of global standards, emphasising that:

"IAS are structured in a systematic way. IAS mainly cover general principles and are therefore by nature less detailed than US GAAP. As a result, IAS are easier to understand and to apply; their systematic structure helps in solving new or complex accounting issues".

Commissioner Bolkestein in a speech in March 2004 emphasised that the Commission has promoted a strategy which is a principle-based approach to financial reporting, designed to reflect economic reality and provide a fair presentation of the financial position and the performance of a company; the Commission remains committed to application of IFRS from 1 January 2005.

High Quality Financial Reporting applying Principle-Based Standards necessarily involves Judgement and Integrity in its application

Each of the parties involved in financial reporting must work within a governance framework which ensures that it assumes its responsibilities and behaves in an ethical manner consistent with the overall objective of ensuring that financial statements provide a fair presentation of the financial position and performance of the company. This means that room must be left for professional judgement in applying the principles, especially to complex, new or unusual transactions. In this respect it is important that the financial statements disclose the effects of key accounting treatments chosen using that professional judgement. The emphasis on professional judgement presupposes that such judgement will be applied with objectivity and integrity by preparers and auditors alike, given the underlying objective of fair presentation of the economic substance of transactions and events. The enforcement mechanism and the penalties associated with non-compliance should be in line with the overall objective. The legal framework also needs to accommodate a principle-based professional judgement system rather than only a rule-based 'safe harbour' regime.

With high quality global standards, capital market confidence in financial information will increase, global investment will be facilitated and the cost of capital will decrease.

Convergence

Conflicts between different sets of accounting standards impair the comparability of financial information and therefore convergence is needed, not only at European level but also worldwide. Accordingly, FEE welcomed the memorandum of understanding of 29 October 2002 whereby the IASB and FASB agreed to work together towards convergence of global accounting standards. In March 2004 the Financial Stability Forum expressed support for both progress in the convergence project and the work of all parties to finalise IAS 39.

Convergence must of course involve an approach of seeking the best principle-based solutions for accounting issues and should demonstrate fully that experience from across the globe has been utilised.

Endorsement of IFRS

The Commission has endorsed IFRS 1 on first time adoption, as well as all existing IAS with the exception of IAS 32 “Financial Instruments: Disclosure and Presentation” and IAS 39 “Financial Instruments: Recognition and Measurement”, on the grounds that IAS 32 and IAS 39 were in the process of being revised in cooperation with European and other accounting experts.

It would be in the interest of financial reporting in Europe for the standards on financial instruments to be endorsed as soon as possible now that envisaged elements have been issued by the IASB, with the improvements project finalised in December 2003 and the fair value macro hedging of interest positions in March 2004. In Europe’s interests, there should be no differences between IFRS and endorsed IFRS. For this reason FEE is opposed to any form of separate European standards. European standards could be perceived as second best to international standards; and US GAAP is not considered a suitable alternative.

IFRS 2 Share-based Payment, IFRS 3 Business Combinations, IFRS 4 Insurance Contracts, IFRS 5 Non-current Assets Held for Sale and Discontinued Operations have been issued by the IASB in 2004 and also these standards should now be endorsed promptly by the Commission.

Europe needs to contribute to the standard setting process at IASB before a standard or even an exposure draft is issued in order to arrive at the best technical and practicable standards. We see this as EFRAG's most important role. FEE and nine other 'founding fathers'[*] established EFRAG to have a strong input into this process and to ensure that relevant European positions are considered. FEE continues to give its full support to EFRAG. FEE comments on all draft comment letters to IASB issued by EFRAG and has an active role in the EFRAG Supervisory Board. With the enhancement of the role and structure of EFRAG, EFRAG has started to develop further its input to IASB.

Consequences and Risks of Non-Endorsement

Use of non-endorsed standards

The EC paper of November 2003 commenting on the IAS Regulation and the Directives[**] clarified the position on standards that are not yet endorsed or rejected:

"To the extent that a standard has been rejected by the EU but is not inconsistent with endorsed standards and is consistent with the conditions set out in IAS 1 paragraph 22, it may be used as guidance. To the extent that a rejected standard conflicts with a standard which has been endorsed – for example where an endorsed standard is amended – the rejected standard may not be applied. The company must continue to apply fully the standard endorsed by the EU".

Uncertainties related to endorsement

Many efforts have already been undertaken by reporting entities, auditors and users of financial information to achieve a timely and effective conversion to IFRS. Should endorsement of the standards not take place within the anticipated timetable, this would have significant consequences for the capital markets in Europe. The commitment to comprehensive and transparent reporting expressed in the IAS Regulation will be difficult to achieve if IFRS are not endorsed promptly, and this may negatively impact confidence in financial markets. In addition, it would create major uncertainties for users, preparers and auditors who have committed themselves to have IFRS in place by 2005, as well as for those enterprises which already apply IFRS, including IAS 32 and 39, and those which intend to do so shortly. Companies in other countries in the world, including those in many developed countries, will have to follow the complete set of

[*] UNICE (Union des Confédérations de l'Industrie et des Employeurs d'Europe), EBF (European Banking Federation), ESBG (European Savings Banks Group), GEBC (European Association of Cooperative Banks), CEA (Comité Européen des Assurances), EFFAS (European Federation of Financial Analysts Societies), FESE (Federation of European Securities Exchanges), UEAPME (European Association of Craft, Small and Medium-sized Enterprises) and EFAA (European Federation of Accountants and Auditors for SMEs)

[**] Comments concerning certain Articles of the Regulation (EC) n° 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards and the Fourth Council Directive 78/660/EEC of 25 July 1978 and the Seventh Council Directive 83/349/EEC of 13 June 1983 on accounting.

IFRS. It should be clear that Europe will only be well served in the area of financial reporting when a consistent and comprehensive set of reporting standards is in place in order to meet the key objectives of comparability and consistency.

Implications of any possible European standards

A possible European standard in one or more areas would raise all kinds of questions in relation to development and due process of such a standard – especially where no appropriate national standard is available:

- extra disclosures to explain differences from IFRS for transparency reasons;
- audit implications;
- the risk of setting a precedent;
- system changes implications of any unique European standards in any area such as IAS 39; and
- the risk that some financial institutions, banks or insurance undertakings that apply or want to apply IAS 39, will be seriously disadvantaged.

Companies would no longer be able to claim that their financial statements were prepared under IFRS, with related consequences for the audit report which could no longer refer to IFRS as the reporting framework. It might be necessary to create a separate "European audit report", which might not be recognised at international level. Europe would have its own standards, which might be close to IFRS but not the same as IFRS, and thereby risk failing to achieve global acceptability, affecting access to global capital markets and increasing the cost of capital.

If 'European IFRS' were to be created, the real losers would be the EU and its business community, as their credibility would be undermined and access to capital markets could be restricted or made more expensive. Moreover, if companies were unable to apply the full set of IFRS, they would not be able to utilise the transitional provisions of IFRS 1, a situation that could be very detrimental. IFRS 1 applies only for first time adoption when there is an explicit and unreserved statement of full compliance with all of IFRS. IFRS 1 has been endorsed by the Commission, but can only be used when all the other existing IAS and IFRS are endorsed.

There would also be a clear loss of opportunity for convergence with US GAAP. This would substantially lower the prospect of acceptance by the SEC of the use of IFRS without reconciliation for SEC registrants accessing US capital markets. There would be a risk of severe damage to the reputation of Europe in the US on financial reporting and probably other issues of reporting, enforcement and auditing. It is time for companies, users and standard setters to try to achieve the 2005 deadline. The IASB guidance, although not perfect, is the best available and can be made better; it will significantly improve the quality of accounting and financial reporting in the EU.

It is important for European companies to have certainty about the contents of standards and the timetable of endorsement. Not endorsing a standard may also create a precedent.

IASB Due Process

FEE appreciates the great effort that the IASB and its staff have made to adapt and accelerate their work in order to deliver the stable platform of a comprehensive set of high-quality global standards available for implementation in 2005, against the backdrop of many demanding issues needing to be resolved. Standard setting is a continuing process since standards need to be adapted for changes in the environment and kept up to date. Standards will need to be improved continuously within the limitations of practical application.

The IASCF Constitution Review is expected to improve the due process and consultation process of the IASB, ensuring that its standards are high-quality and broadly supported. The IASCF announced on 22 March and 7 May 2004 its next steps for the constitution review, including consultative arrangements of the IASB, voting procedures of the IASB and the resources and effectiveness of IFRIC and SAC. IASB itself announced on 24 March 2004 that it has initiated an internal review of its own deliberative procedures alongside the IASCF review.

Enforcement

FEE has repeatedly argued in favour of stronger enforcement systems with more powers and resources to enforce the application of accounting standards by listed companies and a proper coordination between national enforcement bodies. It is crucial that effective enforcement for IFRS is in place by 2005.

FEE published a Discussion Paper on Enforcement of IFRS within Europe and on the European Enforcement Coordination respectively in April 2002 and November 2003 and organised a round table on Enforcement in October 2003 in which the above initiatives were broadly supported. Enforcement should be built on effective national enforcement bodies. FEE supports and welcomes CESR standard No. 1 on enforcement of financial information and standard No. 2 on coordination of enforcement activities and encourages timely implementation both by CESR members and other enforcement bodies.

In addition, in December 2003, CESR issued a Recommendation on "Additional Guidance regarding the Transition to IFRS" and called inter alia for narrative disclosure on the transition to IFRS in 2003 year end financial statements.

IAS 39

IASB inherited IAS 32 and 39, which were already in place when the IAS Regulation was adopted in July 2002. However, the Commission has not yet endorsed IAS 32 and IAS 39. IAS 39 and the further amendments published on 31 March 2004 have been criticised by many in the European banking and insurance industry. However, HSBC, Europe's biggest bank, has announced its "intention" to adopt all IFRS, including IAS 32 and IAS 39, even if the Commission were to decide not to endorse these standards. We consider this to be a strong signal that Europe should not ignore.

It is noteworthy that Mr John Tiner, CEO of the Financial Services Authority (FSA) in the UK said in mid May in a speech:

"As the deadline is now so very close, I hope very much that the European Commission will move to formally endorse for use in the EU the two IASB standards on Financial Instruments (IAS 32 and 39). It is no secret that IAS 39 in particular is not a perfect standard and that the EU financial services sector has misgivings about potential volatility in earnings. However, especially in recent months there has been a full and transparent debate about the major concerns and I believe all parties have worked hard and collaboratively to understand and, where appropriate, accommodate these. It is my impression that there is a growing belief that it is better to accept the standard as it is currently drafted for use in 2005 and seek to improve it after that. The FSA shares that view. We are concerned that EU listed companies do not yet know how they will be required to account for the most important financial assets and liabilities on their balance sheets. And we are only a few months from the start date. It is more important to have certainty at this stage than to strive for perfection."

The IASB published in December 2003 revised standards on disclosure and presentation of financial instruments (IAS 32) and recognition and measurement of these instruments (IAS 39) with the exception of certain issues, notably macro hedging. The separate exposure draft on hedging has resulted in an amendment to IAS 39 on Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk (published 31 March 2004). Discussion will continue on another aspect of IAS 39, namely an additional hedging methodology and the balance sheet presentation of certain hedges. Some complex and difficult issues remain unsolved and certain parties continue to express concerns about IASB and even call for a European version of IAS 39. Whether this would be wise is open to question.

The IASB has issued an exposure draft in relation to modification of the full fair value option, in order to address the main concern of the European Central Bank, which is the risk that the full fair value option might be used inappropriately.

Should IAS 39 and/or IAS 32 not be endorsed, a number of technical issues would arise: many other standards such as IAS 12 (provisions), IAS 27 (consolidation), IFRS 4 (insurance phase I) and IAS 21 (foreign currency) contain cross references to IAS 39. In particular, IAS 21 would be seriously affected, as the net investment hedging rules have been transferred to IAS 39. In addition, there is the problem of application of IFRS 1 as referred to above.

The IASB has expressed a clear willingness to continue to work to improve IAS 39 in the longer-term. In February 2004, the IASCF invited senior representatives from European banking, securities and insurance regulators, the accounting profession and the banking and insurance industries to form a high-level European consultative group to advise the IASB. The Commission is an observer to this group. The group will advise the IASB on longer term issues which centre on the application and extent of fair value accounting appropriate for regulated financial institutions in the banking and insurance industries. This process is likely to take several years.

With the publication of the macro-hedging amendment to IAS 39, the IASB announced its intention to set up an international working group to examine the fundamentals of IAS 39 with a view to replacing the standard in due course. The IASB believes that it has an opportunity for a fresh look at IAS 39 with a view to examining the fundamentals of the standard. The financial instruments working group will assist in improving, simplifying and ultimately replacing IAS 39 and examine broader questions regarding the application and extent of fair value accounting – a topic on which IASB has not reached any conclusion. Although any major revision of IAS 39 may take several years to complete, the IASB is willing to revise IAS 39 in the short term in the light of any immediate solutions arising from the working party's discussions. The only restriction on a fresh look is the IASB's Framework. In the meantime, we believe that the revised versions of IAS 32 and IAS 39 and related amendments should be endorsed for application in Europe from 2005.

In scandals both in Europe and elsewhere it is evident that a part of the problems arose from complex financial transactions, including undisclosed-off balance sheet transactions, misuse of special purpose entities (SPEs) and related party transactions and poor reporting practices concerning financial risk management. It is therefore essential to have in place robust global accounting standards on financial instruments and special purpose entities.

At present, no EU Member State has a comprehensive standard on financial instruments. The absence of disclosure and measurement standards is a major risk as the use of derivatives, SPEs and financial instruments is increasing rapidly and has been at the heart of several scandals.

In any case, some EU Member States are moving ahead of the Commission's endorsement process. For example, on 16 April 2004, ASB published proposals, including that from 1 January 2005 (i) all listed entities using UK standards, and other entities choosing to adopt fair value accounting, should apply the measurement and hedge accounting requirements of IAS 39; and (ii) all entities should apply the requirements of IAS 32. Entities applying the Financial Reporting Standard for Small Entities would be exempted.

Conclusion

FEE calls on all parties to agree to reasonable solutions in a cooperative manner in order to have a global standard on financial instruments available for endorsement in 2004, thereby providing Europe with a comprehensive set of IFRS, identical with full IFRS. European listed companies need certainty on the contents of applicable standards and the timetable for endorsement in order to prepare appropriately and in good time their transition to IFRS. Further, FEE calls on all parties in Europe to provide the necessary input to find proper solutions. Parties are urged not to lose sight of the wider financial and economic objectives, including financial stability, efficiency and transparency that underlie the need for internationally convergent standards. The benefits of the use of IFRS will only come to Europe if endorsed IFRS is the same as IFRS. Only global standards will bring the benefits of increasing confidence in financial information, facilitating global investment and reducing the cost of capital.

Appendix I - Background Material

- 1999 FEE Discussion Paper on a Financial Reporting Strategy within Europe
- FEE letter to SEC of 22 May 2000 on SEC Concept Release International Accounting Standards
- 2002 FEE Discussion Paper on Enforcement of IFRS within Europe
- FEE letter to EFRAG of 3 October 2002 on EFRAG Preliminary Comments on Proposed Amendments to IAS 32 and IAS 39 Financial Instruments
- FEE letter to IASB of 21 October 2002 on ED of Proposed Amendments to IAS 32, Financial Instruments: Disclosure and Presentation, and IAS 39, Financial Instruments: Recognition and Measurement
- FEE letter to FASB of 28 January 2003 on FASB Proposal Principles-Based Approach to US Standard Setting.
- 2003 FEE Discussion Paper on European Enforcement Coordination
- FEE letter to IASB of 1 December 2003 on ED on Proposed Amendments to IAS 39 Financial Instruments – Fair value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk
- FEE letter to EFRAG of 1 December 2003 on EFRAG Preliminary Comments on Proposed Amendments to IAS 39 Financial Instruments – Fair value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk