

Policy Statement

Standing for trust and integrity

December 2008



The Accountancy Profession's Contribution to the Debate on the Crisis (I)

Reflecting on the Crisis

FEE, the Federation of European Accountants – Fédération des Experts comptables Européens, wishes to contribute its views and experience to the debate on the current crisis, the ways to mitigate its effects and to speed up recovery. This paper takes a broad perspective on the crisis; two other papers look at matters of specific relevance for statutory auditors during the financial crisis (II) and the particular situation of SMEs (III).

About FEE

FEE represents 43 professional institutes of accountants and auditors from 32 European countries, including all 27 EU Member States. It has a combined membership of more than 500.000 professional accountants. In representing the profession, FEE recognises the public interest. Professional accountants work in different capacities in public practice, business, and public sector; based on the practical experience gained in this daily involvement in all aspects of the economy and the set of values underpinning the profession's practice, FEE believes it has a contribution to make in the current discussions.

Background

The gradual evolution of the crisis from the US subprime mortgage market to the global economy is evident. Consumers, investors and companies are all suffering a severe crisis of confidence. Banks that were reliant on the money markets for ongoing liquidity have seen those funds dry up. Investors have seen share prices decimated. Companies face lower margins and volumes and a greater need for bank finance, just as banks are seeking to improve their capital ratios by reducing lending.

The combination of low availability of credit and high levels of personal and corporate borrowing is dangerous. In addition, many companies are responding to the threat of recession by reducing staff numbers, delaying investment and expansion, which is further depressing market confidence.

In a difficult economic climate corporate fraud is more likely to be perpetrated and detected and can have an even more detrimental impact on fragile and volatile businesses, than in normal economic conditions. Detection of fraud is the primary responsibility of the

board but proper attention needs to be paid by the whole financial reporting chain.

The accountancy profession has an important contribution to make in helping to restore market confidence and engendering trust between market participants.

General comments

A measured response is needed – but decisive action should be taken where needed. In the short term, governments, the European Commission and regulators must take whatever action is necessary to address immediate difficulties. However, policy makers must take care that they do not rush into 'knee jerk' responses that could have little practical value but cause further damage to the economy.

Helping to restore confidence is what the accountancy profession does. Accountants, whether in practice, business or the public sector, increase confidence in financial information. The profession has a key role to play in enabling users, including lenders, to have more trust in financial statements and enabling businesses to communicate

more effectively to stakeholders.

Financial reporting is key for restoring market confidence

It is essential that financial reporting continues to provide stakeholders with the information they need. The needs of investors, the primary users of financial statements, must come first.

FEE shares the analysis on fair value measurement of the Report on the Financial Crisis prepared by René Ricol, past President of IFAC, for President Sarkozy: *"This method of valuation shows up gains and losses very quickly and is therefore a major and beneficial advance in financial reporting. The volatility of mark-to-market valuations, as compared with historic cost, merely reflects the economic reality of market participants' positions."* It is helpful that IFRS revealed the economic reality of market participants' positions at an earlier stage than otherwise would have been the case.

The impact of the interaction between prudential regulation and financial accounting rules on the financial turmoil needs to be analysed as indicated

in the recent G20 declaration in order to ensure that regulatory solutions against pro-cyclicality are identified and implemented.

The IASB has provided guidance on important issues such as measuring and disclosing the fair value of financial instruments in illiquid markets, and has amended certain standards to enable conditional reclassification of certain financial instruments. FEE supported the prompt EU adoption of these changes. This action aimed to restore a level playing field between banks and other financial institutions reporting under IFRS and those using US GAAP. However FEE cautions against further significant changes without taking appropriate time to think through the consequences. Moreover any European departure from IFRS could damage investor confidence and competitiveness of European businesses, and seriously undermine the process of global financial reporting standards convergence.

The governance of the IASB in the public interest and the independence of the IASB, the global standard setter for financial reporting must remain undisputed. FEE believes that the IASB has demonstrated its ability to react in an appropriate, prompt and effective way to important issues. However it has been argued that, in the course of this debate, political pressure on the independent standard setter exceeded an acceptable level.

At the European level, it is vital that EFRAG is adequately equipped to be proactive vis-a-vis the IASB at a very early stage in the standard setting process. This can only be achieved through enhancing EFRAG which is best placed to inform the IASB on financial reporting issues from a European perspective and to contribute to finding the best answers to complex problems initiated or highlighted by the financial turmoil. Consequently, EFRAG needs to be empowered and receive the necessary resources at EU and at national level.

Proper coordination, consultation and a robust due process in the IASB standard setting process are the best safeguard of quality, appropriateness and independence.

Corporate governance is a vital part of the system

Corporate governance processes are complex and interconnected with other systems, including financial reporting, auditing, corporate communications and others. Changes in one area may have unintended consequences in another, and it is therefore important that any proposed amendments are given full consideration. In particular, proper risk management processes are essential.

FEE is fully supportive of the EU provisions regarding audit committees, corporate governance and risk management. Unfortunately, the recently published scoreboard on the transposition of the Statutory Audit Directive shows that transposition by Member States lags behind in particular regarding audit committees (article 41 of the Statutory Audit Directive). These provisions should be adequately transposed and enforced before any further reform is considered.

It is the responsibility of Audit Committees to monitor the effectiveness of internal controls. While a lot of attention has been attached to the independence of members of Audit Committees, their expertise and their ability to adequately and responsibly fulfil their role remains essential.

It has become readily apparent that there are dangers in capital markets focusing excessively on short term objectives and encouraging short-termism in management and investment. Employee and director reward schemes should be made sustainable. FEE believes that performance-based remunerations should have regard to long-term effective and socially and environmentally responsible performance (sustainability reporting), thus reducing any unintended short-term incentives to irresponsible risk-taking and income management. However any potential changes should be introduced after due consultation, and with care to ensure that companies remain able to compete for the best talent.

Better regulation: quality not quantity

Regulators need to strike the right balance. FEE believes that new or revised regulations should only be developed where there is clear evidence that the benefit they provide to society as a whole are greater than their costs.

Appropriate investment by national authorities in regulatory resources is key to the functioning of financial markets. The right balance needs to be found between the authority of various national regulators and that held at pan-European level (CESR, CEIOPS and CEBS).

In the final analysis the causes of the crisis derive from individual behaviours of market participants and the motivations behind these behaviours. All this highlights **the importance of ethical standards.** The accountancy profession will continue promoting integrity, objectivity, professional competence and due care, confidentiality and professional behaviour amongst its members, who are all bound by the IFAC Code of Ethics whether they are in practice or in business. ■