PIRC

Pensions & Investment
Research Consultants Ltd

6th Floor, 9 Prescot Street
London E1 8AZ

Telephone +44 (0)207 247 2323
Fax +44 (0)207 680 4081
Email info@pirc.co.uk

www.pirc.co.uk

Michel Barnier
European Commissioner for Internal Market and Services
European Commission
BERL 10/034
B - 1049 Brussels
Belgium

1st July 2011

Dear Monsieur Barnier

Accounting Standards and the banking crisis – the role of the AICPA and EFRAG

We note that the EU endorsed IFRS, including IAS 39, further to advice from European Financial Reporting Advisory Group ("EFRAG") a body that was not and is not independent of the interests of the large accounting firms.

IAS 39 contains the loan loss model "incurred loss" that is known to be faulty, and has had particularly devastating consequences in the United Kingdom and Republic of Ireland where IAS 39 was used for the accounts of banking companies.

PIRC has undertaken research into how this standard came to be adopted and how it does, or does not, fit with law.

True and fair view

PIRC notes that the requirement in the IAS Regulation (of the Council) is for an EU-IFRS to only be endorsed if it is not contrary to the requirement that accounts should give a true and fair view.

It seems difficult to sustain a position that IAS 39 ever did or could show a true and fair view, by the meaning of either EU Law, or UK or Irish Law. The true and fair concept came in to EU law, via the British model of company law, in the 4th Directive. It is very clear in English Law that the true and fair view relates to the integrity of the accounts of which capital maintenance is the critical factor. The members and directors, once the accounts are signed, are entitled to rely on it.

However, IAS 39 is absolutely at odds with the principle of capital maintenance. The "incurred loss" model of paragraphs 59 and paragraphs AG89 and AG90 exclude loss recognition in such a way that applying IAS 39 is wholly incompatible with maintaining true capital as stated in the accounts.

Regulated by the FSA.
Pensions and Investment Research
Consultants Limited is Registered
in England and Wales. No. 2300269.

PIRC notes that applying IAS 39 will come up with a compliance based number for "impairment", for which the carrying value of loans in the accounts is merely a balancing number.

IAS 39 does not even attempt to calculate - hence it does not give assurance on - the recoverable amount of loans, which £ for £ affects capital and whether a bank is a going concern or bankrupt.

So far as preparing the accounts and the audit of those accounts is concerned, IAS 39 appears to create a limitation of scope - or the impression that it has limited scope - which in practice is highly dangerous. Good and bad loans may have exactly the same observable impairment characteristics in the short run, but represent entirely different inherent recoverable amounts.

PIRC is specifically asking the Commission to discover whether EFRAG has used any objective yardstick by which to assess whether any International Accounting Standards Board ("IASB") accounting standard gives a "true and fair view", or, as seems to have been the case, whether EFRAG judged "true and fair" based on a plurality of its subjective opinion rather than objectively referring to the law.

The adoption of the "incurred loss model" by the IASB from the American Institute of Certified Public Accountants ("AICPA")

PIRC has also looked into the circumstances by which the defective loan loss model of IAS 39 was adopted by the IASB in 2003. The loan loss model that the IASB adopted came from a proposal from the loan loss committee of the AICPA - the trade body and lobbyist for the accounting firms in the USA. The AICPA proposed this in its "Proposed Statement of Position"- which was published in 2003[1].

IAS 39 had had an expected loss model in it but this standard was re-exposed in 2002. It is clear from evidence from that time that IASB then switched its model, after the exposure draft, from an expected loss to incurred loss model at the same time that the AICPA was reaching its conclusions, despite the IASB having led people to believe, in what its exposure draft had said, that it was proposing an expected loss model[2].

One assumption that might be made is that this equivocation arose as the IASB was waiting to see where the AICPA was going. However, what transpires is that despite the IASB having adopted the AICPA proposal it was not then actually accepted in the USA, as it met with opposition from parties including US banking regulators[3].

However, in Europe, the IASB position, supported by some accounting firms, seems to have been sufficient to have been able to beat off banking regulators. The question therefore arises, was the IASB following the AICPA's interest despite it being fundamentally unsound, and inconsistent with both EU and national law on the systemically critical issue of capital maintenance?

---

[1]AICPA Statement of Position
http://www.bdbonline.biz/pdfs/expdraft61903.pdf

[2] Accounting Standards Board "Inside Track" April 2003
http://www.frc.org.uk/asb/publications/it5_p33.html
Commission Bancaire, France, Annual Report 2003 page 104, http://www.banque-france.fr/gb/supervi/telechar/cbreport/annual-report-commission-bancaire-2003.pdf

[3] http://www.bankaudit.net/Loan%20Reviews/LR_aicpa_SoP.html

From the evidence that PIRC has seen, it seems that Europe got a catastrophically defective standard causing corporate governance – which is dependent on reliable accounts - and banking regulation – which is dependent on the same accounts - to fail where the standard was used in banking companies, due to:

- the IASB adopting an AICPA proposal that even the US authorities rejected.
- EFRAG with coincident interests with the membership of the AICPA, then recommending adopting it, despite clear conflicts with both EU law and the particular law of particular member states.

PIRC notes that the Commission said in its Green Paper.

"Current practice would seem to indicate that the "reasonable assurance" referred to above is less targeted at ensuring that the financial statements give a true and fair view and more geared to ensuring that the financial statements are prepared in accordance with the applicable financial reporting framework[4]."

This is self evident if it is adopted accounting standards themselves that are not giving a true and fair view as the IAS Regulation required for their adoption.

PIRC would be happy to meet to discuss some of the implications of this letter.

There are some significant public policy issues here regarding the governance of the accounting standards setting process and the basic interpretation of law, that in the case of the UK and Ireland applied from 1879 and earlier.

Yours sincerely

Alan MacDougall
Managing Director
AlanM@pirc.co.uk

Tel: +44 (0) 20 7392 7870

cc: Syed Kamall, MEP

[4] European Commission, Brussels 13 October 2010, "Audit Policy: Lessons from the Crisis"