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The European Federation of Financial Services Users
Fédération Européenne des Usagers des Services Financiers

EuroFinUse's Recommendations to Mr Philippe Maystadt, Adviser to enhance EU's role in promoting high quality accounting standards

5 July 2013

ID number in Transparency Register: 24633926420-79

The European Federation of Financial Services Users
76, rue du Lombard, 1000 Brussels - Belgium
Tel. (+32) 02 514 37 77 - Fax. (+32) 02 514 36 66
e-mail: info@betterfinance.eu - http://www.betterfinance.eu

Executive Summary

The European Federation of Financial Services Users welcomes the appointment of last March 2013 by Commissioner Michel Barnier of Philippe Maystadt as Special Adviser to enhance EU's role in promoting high quality accounting standards. We believe there are important questions to be dealt with at this very precise moment as regards accounting standards setting. Indeed, our organization has been intensively working on corporate governance issues representing the interests of individual shareholders, retail investors and other financial services users. We believe that one of the most important elements for the protection of investors' interests is appropriate accounting standards. Plus, internationally valid standards are more than desirable as cross-border investment relies on the availability of understandable information at the disposal of investors: if accounting is based on different principles there is no use of it for foreign investors.

Therefore, we would like to focus on certain key points that should in our opinion be addressed in this assessment:

I. Accounts should reflect a prudent, true and fair view;

II. Accounting standards should include the notion of stewardship;

III. There should be a convergence of EU accounting standards (4th Company Law Directive) and international standards (IFRS) in place. However, this process of convergence should in no case mean abandoning the European "prudent" accounting approach, which should be imperative over the "neutrality" principle;

IV. The structure of EFRAG should be reviewed and rebalanced to address the lack of representation of not only "users", but especially of "end users", which is a title that ultimately corresponds to investors, be they individual or institutional.

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I.I. Prudence

EuroFinUse believes in the appropriateness of the concept of prudence as risk cannot be appropriately measured, according to numerous evidences. Indeed, banks are allowed to have "risk adjusted capital"; but virtually no-one foresaw the extent of the crisis and interbank market coming to a halt.

Accounts did not give any warning of the financial crisis. One example was raised by the UK banking commission. The accounts of a bank called HBOS showed provisions of about 300 mn euros for the year to 31 Dec 2007. Around 28bn euros were in fact written off in the next 4 years. We believe there were some clues as to what was coming; but the accounts did not reflect those clues. This was, at least in part, because accounting standards have progressively reduced the importance of the concept of prudence and eventually in the 2010 Conceptual Framework the IASB removed it completely. They said the concept of "conservatism" (as defined in United States) was biased; an affirmation which in this case is unproven.

Several personalities such as Lord Stevenson, chair of HBOS said the financial crisis was unforeseeable. But it happened and demonstrates that we can never know what the future will bring. Another example: The London Times newspaper recently commented that the statistical odds of gold dropping in price as steeply as it did were once in 4700 plus years; but this happened earlier this year.

Not having prudence was in itself a bias (concretely, a bias to optimism) and to the unjustified view that we are able to really measure risk.

There is also the legal requirement for accounts to be drawn on a prudent basis: *"valuation must be made on a prudent basis, and in particular only profits made at the balance sheet date may be included"*[1]. These requirements have been reinforced by several court cases such as Tomberger (1996), Bauunternehmung (1999) and Banque Internationale pour l'Afrique Orientale (2003). Unfortunately the Conceptual Framework of the IASB has dropped this concept. The IASB has said, through its chairman Hans Hoogervorst in a speech to the London School of Economics last November that "*the Conceptual Framework is the foundation of our standards"*[2]. Therefore, we are sceptical on how can standards which do not include prudence comply with EU law, and especially with the EU 4th Directive on Company Law.

[1] Article 31 c) of Directive 78/660/EEC (4th Company Law Directive)
[2] http://www.ifrs.org/Alerts/Conference/Documents/HH-LSE-November-2012.pdf

IFRS, on the other hand, include unrealized profits- and these can be calculated on assumptions only (e.g. Mark to Model[3]). This has required the UK ICAEW to issue guidance involving over 140 pages attempting to reconcile IFRS to the law, both UK and EU. In addition, IFRS accounts are not required to show the distributable profits.

The IASB has attempted to defend its position and argued that even though the concept of prudence is not in its Conceptual Framework it is in individual standards. UKSA, a member of EuroFinUse, has prepared a note seeking to indicate the inconsistencies in this IASB position and a copy is attached (Attachment 1).

Several other stakeholders support this view: EFRAG and a number of European standard setters have indicated that they would like the position of the concept of prudence to be reconsidered (see Attachment 1). The French standard setter ANC has asked for proposals from academic institutions to reconsider the role of prudence. ANC has also responded to the EU consultation on long term investment with a paper "Think long term first" which reinforces the need to restate certain basic accounting principles[4].

I.II True and fair view

The 4th Directive says "*annual accounts must give a true and fair view of a company's assets and liabilities, financial position and profit or loss*". This includes the idea of maintaining the capital of the company and ensuring that dividends are only paid out of "*profits made*", according to the 4th Directive on Company Law.

A group of large and individual UK investors[5] has recently sponsored an opinion from a leading UK lawyer into the legality of IFRS under both EU and UK law, who stated that *"as to this the short point is that in the absence of any permissible true and fair view override the standard will have been one which was not properly capable of being adopted, it will have failed to meet the threshold requirement in Article 3(2) of the IAS Regulation, that in order to be adopted standards*

[3] Asset pricing method based on financial modelling instead of market value, especially appropriate for largely illiquid assets

[4] http://www.anc.gouv.fr/files/live/sites/anc/files/contributed/Normes%20internationales/Commission%20europ%C3%A9enne/Livre_vert_ILT_anglais.pdf

[5] http://www.uss.co.uk/Documents/Concerns%20with%20IFRS%20in%20the%20EU%20-%20a%20long%20term%20shareholder%20position%20paper%2023%20Nov%202012.pdf

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must not be contrary to the true and fair view Principle (40) which by Article 2(3) of the Fourth directive and Article 16(3) of the Seventh Directive is required to be encoded in the legislation of Member States"[6].

Resolution of this concern will require a full review of the presently EU approved IFRS.

II. Stewardship

The IASB defines the objective of its standards as being to produce *"information useful to existing and potential investors, lenders and other creditors*"[7]. As stated above, there is no reference to a "true and fair" view or to the idea of stewardship. UK's Kay Review defines stewardship as "*the mutual confidence based on trust in the agent with whom money has been placed, and respect by that agent for the saver whose money has been placed*"[8]. This should prove true for all investors (especially individual, who are often the most vulnerable in cases of stewardship failure, but also institutional[9]) and be especially enforced when the relationship between the agent and the saver is a long term one. In conclusion, investors need accounts to demonstrate how their money has been used and if the stewardship duty is properly exercised.

III. International Standards

We support the idea of international accounting standards. We agree with the G20 endorsement in 2009 of the aim of establishing a single set of high –quality global accounting standards. We believe that such high quality standards will strengthen the financial system and reduce the prospect of similar crises occurring in future.

We believe in widely accepted accounting standards as long as they produce the right answer, but we share growing concerns with several stakeholders that unfortunately we are not on the right track. For example, on the 19 June the UK Parliamentary Commission on Banking Standards stated that "there is clearly widespread concern about IFRS and the method by which it is introduced into EU law"[10].

[6] http://www.uss.co.uk/Documents/BompasQConIFRSMar2013.pdf
[7] IASB Conceptual Framework, page 2
[8] The Kay Review of UK Equity Markets and Long-Term Decision Making, page 65
[9] This view has been supported recently by Standard Life, a large UK investment manager, in a letter to the Financial Times
[10] Fifth Report of the UK Parliamentary Commission on Banking Standards, "*Changing Banking for Good*", Chapter 9, paragraph 1028

IV. Role and composition of the EFRAG

We acknowledge the importance of the European Financial Reporting Advisory Group (EFRAG) and its potential to positively influence accounting standards setting not only in the EU but also –and more importantly- at global level. However, we are equally concerned for the imbalanced representation in the supervisory board of EFRAG of investors, and more concretely of retail investors, versus other stakeholders. As a matter of fact, retail investors are stakeholders who rely heavily on financial reporting and accounting information, as they have little means to conduct independent research themselves; therefore, we feel they should be appropriately represented in the EFRAG Supervisory Board.

EFRAG should have a much more balanced representation as it benefits from public funding and as a consequence be seen to contribute to the public interest. In particular, of the 17 current members of the EFRAG supervisory board, there are only 4 representing the "user" side. The rest of members of the supervisory board are representatives of national reporting authorities, auditors, accountants and executives of listed companies[11]. Out of the 4 representatives of the "user" side, banks count with3 representatives (increasing from its previous 2 representatives); the other representative is from the asset management side.

We understand that in some cases the "users" label is misleadingly awarded to certain stakeholders that should better be considered as "providers", such as for instance accountants and law professionals, who ultimately are remunerated by the industry. For us, the "user" label is a too broad a category; we believe that instead the "end-user" label should be favoured. We believe that the "end-user" label can ultimately be awarded only to investors or their representatives, be they individual or institutional. As we said before, it is investors' money which is at stake from inappropriate financial reporting; therefore, it is they who are the final beneficiaries of good financial reporting.

At this regard, it is necessary to clarify that, in our view, asset managers are not end-users: they act on behalf of the real owners of such assets and their fiduciary duty is not always properly

[11] A good overview of the initial composition of the EFRAG Supervisory Board is provided in EFRAG's Response to the European Commission Consultation *"Strengthening the European Contribution to the International Standard-Setting Process"*, page 6

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exercised[12]. Therefore, we demand to have a true representation of end-users in the EFRAG Board.

Plus, amongst the current members of EFRAG (BUSINESSEUROPE, the Federation of European Accountants, Insurance Europe, the European Banking Federation, the European Savings Banks Group, the European Association of Co-Operative Banks and the European Federation of Accountants and Auditors) there are no investors represented whatsoever.

V. Main recommendations

In view of the aforementioned points of discrepancy with current IFRS standards and processes, we would like to propose the following lines of action to address the situation:

a) A reconsideration of the present approval process of IFRS standards

b) A reconsideration of present EU approved standards to ensure that they are in compliance with EU law

c) A better structure under which EU's wide views can be obtained and effectively presented in a timely manner to the IASB. Concretely, the governance structure of the EFRAG should be reformed to guarantee adequate representation from the end- user side, e.g. from the investors with their own money at risk. This may involve EFRAG being prepared to accept that end-users will in most cases not be well funded and may need financial assistance to ensure that adequate representation.

Attachment 1: UKSA paper "Prudence is missing", 23 April 2013

Attachment 2: Investor coalition position paper on IFRS, 23 November 2012

Attachment 3: George Bompas' Opinion on the Legality of the IFRS

[12] We share the same concerns as expressed in the Kay Review of UK Equity Markets and Long-Term Decision Making, Chapter 5, *"The Role of Asset Managers"*, especially page 37
We refer extensively to the role of asset managers and to the exercise of the fiduciary duty in EuroFinUse's Position Paper on the European Commission's Action Plan on Company Plan and Corporate Governance