AccountancyAge

Bringing international financial reporting up to standard

by Syed Kamal, 26 Jun 2013

SOMETHING IS AMISS with the numbers. The international standards used to draw up accounts for judging a company's financial health are not up to the job. Investor groups argue that the IFRS, which have been used prior to, during, and after the crash, have clearly not given a ‘true and fair' account of a bank's balance sheet. The discount many banks are currently trading at in the markets against their stated asset value may reflect the fact that many investors lack trust in the balance sheets of banks.

Superficially, in a globalised world, it might appear to make sense to have globally converged accounting standards. However it defeats the object of ensuring financial stability if those standards are not prudentially sound. The reality is American and European accounting models serve fundamentally different purposes, the latter being more concerned with corporate governance concerns than the former. Convergence of these models, mandated by the G20 and encouraged by the International Accounting Standards Board, has led each to be diluted by the other, with damaging implications.

Investors are concerned that the IFRS has encouraged a move away from the principle of prudence, whereby accounts must not overstate assets or understate liabilities, profits should only be booked once they are realised, and sufficient funds are put aside to cover any potential losses. This convention has been replaced by an American-inspired principle of neutrality, which means accounts are always deemed ‘true and fair' if they have ticked all the boxes required by the IFRS. This encourages auditors to move away from exercising professional scepticism when assessing a company's accounts and instead to simply tick boxes.

Box-ticking failed to spot financial institutions recording expected income from complex financial instruments in advance. Financial institutions failed, or had to be bailed out, since they simply did not put aside enough funds to cover their exposure to credit default swaps and collateralised debt obligations. AIG Financial Products was able to build a portfolio of $2.7tn (£1.7tn) in derivatives, resulting in liabilities many times its capacity to pay out.

Accounting practices should be reformed to ensure they provide a genuinely ‘true and fair' view of balance sheets, with appropriate levels of loan loss provisioning in place. This means returning to a system of accounting that pre-dates the convergence project in the early 1980s, before which auditors and accountants would only sign-off accounts if they were sure the company in question was a going concern. The liability implications are potentially far-reaching for auditors and directors, but this should in turn be a driver of better governance. We also need to make sure that European Financial Reporting Advisory Group, the body that recommends whether standards should be endorsed for use in Europe, is fit for purpose.

However, some of the big four accounting firms and those who were behind pushing the IFRS argue that this is not the role of accounts. They say accounting standards should not encourage the build-up of sums of capital to guard against potential losses. Instead they believe legislators and regulators should specify the capital buffers banks need to guard against losses. While legislators tried this with the Basel capital requirements, lobbying by large banks, especially in France and Germany, led to a dilution of these standards. Also, when banks are allowed to create their own models, it is clear they will attempt to game the system and claim their balance sheets are more robust than they might actually be.

In the European Parliament at least there is consensus that all is not right with IFRS. In various reports the Parliament is calling on the Commission to come forward with reform proposals. Commissioner Barnier has hired an IFRS specialist as an adviser and the Commission is expected to come forward with proposals for structural reform of banks later this year which could, and in my view must, contain changes to reporting.

If we cannot trust the numbers, knowing what is happening in a bank or any other firm under IFRS will be impossible. We cannot afford to face the consequences of that again.

This is an excerpt from Banking 2020: A vision for the future, *edited by Steve Tolley. The excerpt was taken from a chapter on IFRS written by Conservative MEP Syed Kamall*