Funding the Future

International accounting standards do not meet the requu…

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The Times has reported this morning (paywall) that:

The legal cornerstone underpinning the entire edifice of bank accounting is defective, according to a QC's opinion that questions the approach by accountants at the top of the profession and criticises their regulator, the Financial Reporting Council.

The potentially explosive legal opinion, seen by The Times, makes plain that the billions of pounds of profits reported each year by UK banks cannot be relied upon to give a "true and fair" picture of the financial position of Britain's biggest financial institutions.

George Bompas, QC, accuses the FRC and the Institute for Chartered Accountants in England & Wales of defective logic in supporting the present accounting standards.

I have also seen the opinion in question, which was prepared for the Local Authority Pension Fund Forum, who I advise on tax matters. The chair of that Forum has said in response to the ruling:

The issues are far from trivial, as exemplified by the banks getting the standards wrong, meaning that the accounts in some cases were catastrophically wrong. The accounting profession has effectively become a 'state within a state', interpreting the law incorrectly to suit its own interests and in LAPFF's opinion against the public interest.

I agree, and think that, if anything, the issue is more significant than the one on which the opinion focusses.

That focus is on whether or not International Financial Reporting Standard properly identify the split in the profits of a company between those that are realised and those that are not. The point is vital: dividends can only be paid out of realised profits (those likely to have resulted in real cash earned) to make sure that a company will remain solvent despite paying a reward to its members. Unrealised profits are not available for the payment of dividends as if used for that purpose they threaten solvency and so the ability of the company to pay its creditors. This is pretty fundamental stuff.

And George Bompas QC is quite clear: because accounts prepared under IFRS do not require that this split be shown, and because the law requires that they do in his opinion, and because there is no other place where the data could be obtained from, meaning that the omission is in effect a breach of the law since those needing the data to check that it is reasonable to trade with the company cannot secure it, then UK accounts prepared on this basis are defective.

I would go a little further than that: since auditors are meant to check this data to ensure dividends are legal not disclosing how they have done so makes their work deficient and their opinion that accounts are true and fair potentially invalid.

The Financial Reporting Council and Institute of Chartered Accountants in England and Wales supposedly addressed this issue last year: George Bompas is quite clear that they have not.

My concern is that the issue has not been taken far enough. This issue of the realised / unrealised profit split is key in another area, which is tax. In broad terms only realised profits are taxed, and for good reason, which is that realised profits alone create the capacity to pay tax. But, if the split is not clear it is not possible to understand how and why tax is due by a company, or for the user of those accounts, including a tax authority, to understand them. I am well aware that the International Financial Reporting Standard Foundation say that this is not their concern and that tax authorities should sort this out for themselves, but I do not agree. When we have outsourced accounting standard creation to an industry controlled body those standards should still be set in the public interest, and it is clear that they are not. The answer is that, very obviously, accounting standard setting, including those for tax, should now come back under parliamentary control. To comply with EU law IFRS can stay in place, but additional disclosure is now vital and needed. And that must be decided upon by the government and politicians and not by firms more concerned with setting up e*xclusive members only clubs or winning consultancy work instead of promoting audit quality.*

I argued against the idea of the state taking control of democracy yesterday, and rightly so. But accountancy is different: this has to be subject to democratic, and so state, control. The time for radical reform in the face of accounting, audit and market failure amongst the firms that dominate the profession has arrived.