London
19th August, 2010

Accounting Standards Board
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Assessing the impact of the Accounting Standards Board ("ASB") proposals for the future of UK and Irish Financial Reporting

I welcome the opportunity to respond to this consultation. I am writing as a member of the UITF, which sits independently underneath the ASB to identify inconsistencies with law and ASB accounting standards and issue guidance to correct those defects. The UITF reviews ASB proposals before they are published in order to identify fatal flaws. I am the sole representative from an investor perspective. I am a former member of the governing Council of the ICAEW.

The proposal is legally flawed at **objective** level and the flaw is already apparent in what the ASB has already done even before this proposal:

- This proposal omits the fundamental objective of creditor protection and capital maintenance (**part of "stewardship")** contrary to the law. The IFRS for SMEs and the full IFRS does not include it. This ASB proposal does not address this deficiency, but instead propagates it far more widely.

- Because the ASB appears not to have fully understood (since before 2004) the law relating to creditor protection[1] embedded in the Companies Act itself, (applying to both companies using IFRS and companies using "UK GAAP"), the ASB has already approved standards that appear to contravene the law in respect of creditor protection. The ASB has no dispensation to break the law. The ASB's role is to set its quasi-legislative standards **under** the law.

- The law is such that shareholders can rely on the profits in the audited accounts -including those of banks - to approve final dividends declared, unless the directors or auditors have indicated to the contrary in the accounts. Overstating profits could lead to an illegal distribution (which is a criminal offence), as well as a breach of Section 386 (also a criminal offence). Some aspects of IFRS do overstate profits and indeed several UK and Irish banks collapsed after paying dividends. They did not have the capital that they presented, and they were not going concerns. The true situation was that business models were loss making and actually consuming capital. The accounts were unreliable for capitalism to function properly as they did not show the capital.

[1] Companies Act **Section 837** – See attachment (page 7)

How can all of this be if **the framework of law** had not changed but the standards supposed to serve it missed the **very point of the law**? The answer is that mistakes were made of such severity that is difficult to overstate it. There is no greater hazard in an economy than banks that have got their accounts in a muddle. I will now highlight some of the differences between two "systems" and their consequences, which I have also covered in more depth in the attachments to this letter.

System 1 (suitable for corporate and banking solvency)

The basic Accounting Rules are an attachment to Company Law itself. Company Law Accounts (i.e. non-IFRS) fit with the discharge of transparent solvency/capital obligations of Section 837, and they are legally superior to UK ASB standards. Companies Act unqualified company accounts should give a discharge of directors duties (ensuring creditor protection, capital maintenance (solvency), dividend safety, reliable profits and assets, etc), **when** they have reported the numbers in the accounts properly. When banks use System 1, throughout and at the end of the year, it produces numbers that should be good enough for solvency, control and profitability. It had been that way in the UK and Ireland since 1879.

System 2 (unsuitable for corporate or banking solvency)

IFRS disapplies the above and then disregards creditor protection and capital maintenance etc, so that following the standards **does not identify that the numbers are unreliable and the business unstable**. That is false assurance in the **absence** of correcting standards. The impact of this has been different and far more dangerous in the UK and Ireland given the extent to which IFRS was rolled out more fully in these states than other parts of the EU. This can be shown below.

Solvency from the Accounting Standards applied	**System 1/UK GAAP**	**System 2/IFRS**
Group solvency and capital addressed?	Yes, group wide, also acts as a check on subsidiaries and parent company.	No. But system should be fairly reliable **if** subsidiaries and holding company accounts have been prepared on a "System 1" basis.
Banking companies and holding companies solvency and capital addressed?	Yes, it establishes proper capital at the level of each company, it acts as a check on each company lending to each other.	No, it not only fails to control capital at the level of each company, it fails to act as a check on each company lending to each other.
Impact	Solid "inside out"	No solidity, lethal combination.

However, IFRS was implemented very differently within the EU even though IFRS applied across the EU. The UK and Ireland used IFRS in **precisely in the wrong place**.

Application in practice after 2005	**France and others**	**UK/Ireland/USA[2]**
Group level	System 1 & System 2/IFRS	System 2/IFRS
Banking companies and holding companies	System 1	System 2/IFRS HAZARD
Impact	Solid, inside out, i.e. truly profitable, but some presentational confusion.	True solvency not accounted for, may be unprofitable, destroying capital, but look profitable.

The Queen asked of the banking crisis "why had no one spotted it coming?" The reason, I submit, is quite simply due to the above. A shared model that had worked in the UK and Ireland since 1879, was replaced by another shared one that produced false profits, overstated capital, misleading creditors, misleading shareholders, the Bank of England, FSA and others.

Although IFRS had been rolled out across the EU, the UK and Ireland implemented it so extensively that the **impact** was different. It has been a "double dose" to the extent of being a deadly dose, by removing what had underpinned banking solvency for over 120 years. In engineering terms it was like a signalman sending a train down the wrong track. The UK had the first failing bank, Northern Rock, which only the month earlier appeared to have so much capital it applied to reduce it. IFRS merely reports the train crash rather than prevents it.

The banking crisis was systemic in the UK and Ireland, including the building society sector, despite having different currencies, different interest rates and different banking regulators. The common factor was a banking system underpinned by a Company Law Accounting Standards system since 1879, then being replaced by a new one from 2005, with one with severe faults with solvency left out. IFRS implementation cost hundreds of millions in some banks, but the real cost has been many, many multiples of that (see table in Appendix).

The root of the error is that the ASB is tasked with setting accounting standards for the purpose of the Act (which includes supporting banking solvency) and not merely "financial reporting standards" for the purpose of the EU capital market Transparency Directive from which IFRS came. A crucial difference and a fatal error. Parliament did not change the required output standard of audited accounts of banks (i.e. repealing Sections 830-837), but the ASB's method of implementing IFRS changed the method of delivery to a sub-standard level.

[2] IFRS used an American Standard "IAS 39" and IFRS is similar to the US reporting system.

What is the IFRS problem precisely?

i) banks are particularly sensitive to the "risk gaps" between what the pre-IFRS regime delivered - and discharged properly - and the IFRS regime does not.

ii) some of what IFRS has offered is positively contrary to the objective of directors discharging their duties properly. False profits, hidden losses and hidden gearing (note: hidden losses are also hidden gearing as capital is overstated) are possible with IFRS.

iii) false profits are enticing and can take in even those close enough to understand the truth. Management assumed they were producing profits, and auditors too have recently been criticised for not being sceptical, but IFRS took out prudence (scepticism) from what was offered in the accounting standards.

The UK has often been accused of "gold plating" EU regulation (i.e. supplementing it). IFRS implementation in the UK was a rare example of the opposite, debasing what had been in place before.

The ASB has made errors in two ways. Firstly, transplanting into its own suite of standards some individual IFRS that have direct clashes with the legally superior Companies Act Accounting Rules, (e.g. incurred loss provisioning in FRS 26, is not using prudence as the Companies Act requires, and is then using the IFRS test of accruals, which is not matching costs and risk, but delaying it). Secondly, it has not set a standard to create a "bridge" between IFRS, where IFRS are used as company accounts, and the Companies Act Accounting Rules in order to still meet the capital maintenance and solvency tests of Section 837. Against Section 837, the standards have not been fit for purpose, but Section 837 is still the legal test.

If a company broke the law of its own volition causing insolvency to the extent that accounting standards can - by being substandard – cause insolvency, its directors would be subject to BIS investigation. Given that applying some IASB/ASB standards positively break the objective of the law, and basic business economics, I believe that the ASB needs to ensure that it is never an accessory to that. It is difficult to see how these things have come to pass. The ASB/FRC was warned by the main UK investor bodies in 2005, that there was a major problem in the offing with the accounting and auditing standards framework[3] not matching the legal framework but it appears to have overlooked that warning.

The proposed further roll out of full IFRS and the IFRS-SMEs has the same fundamental flaws as what has gone so badly wrong in the banks, a level of apparent compliance that undershoots what the law requires. It is difficult in the extreme to envisage Parliament knowingly assenting to a model of company accounts that dilutes the responsibilities of auditors at the same time as offering less for directors, creditors and the wider public interest. This proposal merely seems to be a way of keeping the **produc**t of audited accounts whilst neutering the principal **reason** for having them. Form over substance in fact.

[3] FRC PN 119, 9th August 2005, http://www.frc.org.uk/press/pub0854.html

Given the onerous obligations of directors, an alternative model of accounting to discharge their duties properly and then give assurance to others would need to be set up to address the deficiencies caused by a limited scope accounting standards framework. The purpose of Company Law accounts is focussed on directors' duties, capital maintenance and creditor protection. The objectives in it are a sharp test, like a prism, to deliver that. The "useful for users" concept is mis-focused, relativist and better compared to looking into a crystal ball. It avoids any direct responsibility of anyone for anything to anyone.

In my view, the direction that the ASB took, and is still taking, is not merely causing direct business risk, it is taking up far too much of a businesses' time, and then giving false compliance thereafter. **The system misleads itself creating an aberration of governance under the apparent best practice of it.**

Essentially the post Enron reforms of the FRC have failed Britain and Ireland. The governance systems of both states are a captive of precisely the same fault, false profits from compliance that create a framework for creditor (and long-term shareholder) abuse and wealth destruction. The FRC would work very well if it were not for the direction taken by accounting standards. One popular excuse for IFRS' failings has been the "regulators should have done more". That is difficult when the numbers are wrong in the first place. Furthermore, there are not regulators of SMEs. Rather than working well in a free market economy IFRS ironically requires **more** state control, as it upsets the way that capitalism works, feeding out dysfunctional numbers.

I would be happy to meet to discuss this further preferably with a representative from BIS. I will also be requesting that a copy of this letter also goes to the Irish Government via BIS. In my view the ASB has substantial issues to resolve which require more immediate correction, not multiplication.

Timothy Bush FCA

cc: Richard Carter, Head of Company Law and Investigations, Department of Business Enterprise and Skills

Michael McKersie, Association of British Insurers

Liz Murrall, The Investment Management Association

ICAEW, Institute of Chartered Accountants in England and Wales, Robert Hodgkinson

ICAS, Institute of Chartered Accountants of Scotland, James Barbour

CAI, Chartered Accountants Ireland, Aiden Lambe

Attachments:

Explanation of the conclusions in this letter

The causes and symptoms of regulatory dysfunction and drift

Answers to questions in the Consultation

EXPLANATION OF THE CONCLUSIONS IN THE LETTER

Creditor protection/stewardship

The Companies Act is a governance and solvency act which includes solvency tests for those companies that are banks. The Companies Act has two modes:

- it sets out a standard **expected from** audited accounts in order to protect creditors; these are the solvency rules set out in Section 836 and 837; and

- it sets out how to **prepare accounts** for that purpose in Section 395 and 396.

Since 2005 there are two types of accounts allowed to be prepared **under** the Companies Act:

- "Companies Act Accounts". The rules and formats for preparing accounts are not the property of the ASB, they are in an attachment to Companies Act itself, the "Companies Act Rules", and UK Accounting Standards from the ASB then interpret those, filling in the gaps. (Companies Act rules accumulated over the years from learning from different corporate abuses. BIS ("the DTI") is also an investigatory department of the abuses of the limited liability status).

- IFRS. Which has its own rules and formats, IFRS is accounting rules, formats and standards. IFRS has eliminated the rules and formats that for "Companies Act Accounts" are fixed into the law. (The IFRS model has been heavily influenced by the US-SEC which is not an investigator of the abuse of limited liability status Instead it tries to monitor information that capital markets have in a trading based system, it is **inherently relativist** as different parties have different objectives.)

There is then the matter of how these two systems interact. This is because listed companies have to use IFRS for group accounts, but can still use "Companies Act accounts" for the holding company and subsidiaries.

Dividends and capital maintenance are matters for companies. As the system currently stands, most companies and holding companies in the UK still come under Companies Act accounts. IFRS accounts are therefore generally only applying to the consolidated accounts of listed groups.

The exception is banks, where banking companies and bank holding companies also used IFRS in addition to using IFRS for group accounts by virtue of being listed. The banking crisis has shown that there are serious flaws with IFRS for banks. These are actually creditor protection and "stewardship" problems. Basically, banks overstated the values of their assets and overtraded on that.

The reason that IFRS was a problem for banks was that it has an objective that was applied in a way inconsistent with appraising assets with care (prudence-reliability). The IFRS objective was "useful for users", a test which is ill defined and its interpretation a matter of opinion, thus, ironically, difficult for any user to actually rely on. Abandoning prudence in banks was therefore wholly inconsistent with capital maintenance and creditor protection, where the risk is asset values that go down in the short to medium term.

This was all different when banks used Companies Act Accounts, (pre-2005). In the Companies Act Accounting Rules, one of the basic rules was “prudence” meaning only holding assets at the ultimate realisable amount, and the UK Accounting Standards Board could not change that. Therefore, other than banks, most UK Companies are still working to the old model with “prudence” still in it. Hence for most UK Companies dividends and capital maintenance are still intact under the old-pre IFRS system.

This ASB proposal takes far more companies out of that system, and puts them into the IFRS system where there have been problems with banks. The IFRS-SME is also based on “useful for users” like full IFRS. The IASB made a positive virtue of omitting prudence, and the ASB positively supported that position - despite bank collapses - as late as summer 2009 (see page 11).

The ASB proposal and creditor protection

At UITF meetings in March and May 2010 I raised questions about this proposal due to inconsistencies with the law at an **objective** level, in particular relating to creditor protection. No satisfactory answers were forthcoming; some people even said that creditor protection no longer applied.

The law is such that, whether they are produced as UK Companies Act Accounts or IFRS Accounts, the output should be reliable as evidence to be used to declare a dividend without that being illegal (i.e. out of capital, or funded wholly by creditors).

The purpose is as set out in Section 837 of the Companies Act which says:

> *"the [audited] accounts must have been properly prepared, **or only be defective in ways immaterial in determining** whether the distribution [i.e. a dividend] is in breach of this Part of the Act. (Source: Palmer’s guide to Company Law 2006, and S271 of the 1985 Act).*

This is because companies have limited liability. Shareholders can take dividends, usually in the form of <u>cash out</u> of a company, whereas creditors have the financial interest in <u>what is left behind</u>. These solvency tests are to protect creditors by having reliably audited accounts so that creditors are not left with losses, or that the fixed share capital base - there to protect them - is not depleted. This requirement also protects shareholders who can also be disadvantaged by insolvency, notwithstanding that they may have received dividends out of capital. Clearly, short term share traders might actually benefit from dividend stripping a company with false profits, so might management. That might not be deliberate, but is the risk wherever there are false profits.

For entities that do not pay dividends such as charities, trusts etc, following the same approach as above also ensures that their accounts are also suitable for the purpose of creditor protection, as the test for a limited liability entity is the best test that can be applied to any entity, it’s a stress test. That is the stewardship function of accounts and audits thereof. Underpinning that are the Companies Act Accounting Rules, which include prudence (and other things to support that).

This test also applies to groups where companies may be lending to other entities, i.e. the stewardship of the group and each part of the group is also tested by this stewardship objective. Because of the way that groups of companies interlink, via holding companies, it is particularly important to have a solid framework that is consistent throughout the group to avoid mistakes or abuse. By the test of Section 837 IFRS and FRS 26 are defective.

IAS 39 (under the same objectives as IFRS-SME and IFRS) showed a lack of stewardship with banks

Stewardship is central to the way that Company Law works. Several UK and Irish banks collapsed shortly after paying dividends, i.e. there was a prima facie case that these banks had made inappropriate or illegal dividends, despite having audited accounts that did not reveal that. These banks had used IAS 39, which is set with the same objectives as the IFRS-SME which forms part of this new ASB proposal.

As these banks were UK listed and registered companies, and all of the banks had used IAS 39, the question arises whether their accounts met the test of Section 837. Given that shareholders in law approve dividends at AGMs, based on the accounts presented to the AGM, there must be a question of doubt about the legal validity of resolutions passed at AGMs in 2008 (31 December 2007 accounts, and the year before). Also, any bank that had recently made an acquisition of another bank based on public accounts might find that it had a problem on its hands and become the victim of the other bank's hidden problems.

Despite what appears to be a misconception at the ASB (and to a degree parts of the FRC), Parliament has not changed the laws of creditor protection. **For solvency of companies, BIS (and hence the FRC) is the lead regulator of corporate solvency, whether it is a bank or not**. The name "FRC" does not actually imply that, but it is.

IAS 39 is so inconsistent with the solvency/stewardship purpose required of accounts prepared under the Act to the extent that it positively subverts it. One example is incurred loss provisioning. This requires companies, including banks, to leave out losses by not estimating the cash that won't come back to the bank. The approach instead is to wait until it is clear that it will not come back, by which time it is too late, and the bank might well be insolvent. The FSA has also identified that IAS 39 makes no sense at all in showing true solvency. (See Lord Turner's letter on Dunfermline Building Society to Alastair Darling[4]).

With incurred loss provisioning, the loss left out is likely to be bigger the <u>larger</u> the risk (such as high loan to value mortgages, and low income security, such as buy-to-let). The list of banks given to BIS included situations of that type. The problem also affected non-bank lenders, one large one which had also suddenly collapsed like banks.

However, that is not the only flaw. There are also flaws in the way that IAS 39 can obscure significant loans already defaulting once inside complex instruments such as CDOs. Companies Act Accounting Rules required prudent measurement of assets, and not netting different things off e.g. hiding losses behind other profits or fair value uplifts. IFRS allows netting, as it regards "profit" as the difference between two asset values. So, if an asset contains several things, and it is valued as one (by "fair value") then losses will be obscured. The Companies Act Accounting Rules absolutely prevent that.

[4] [4] www.fsa.gov.uk/pubs/other/response_Dunfermline.pdf, Letter from FSA to the Chancellor.

The flaw for CDOs is that losses in the component parts of CDOs may grow without affecting “fair value” as long as there is still a market for them (but that might be a false market). Losses can eventually reach a tipping point, by which time the market may collapse and the value plummets far below what it is it really worth. This CDO dynamic explains why although some US mortgages were defaulting in 2006, bank losses did not appear in their accounts until Q1 2008. The accounting could delay losses by 15 months, during which time the lending was able to carry on and in the process get riskier as the lending itself was pushing up house prices. Prior to IAS 39, UK GAAP should have revealed losses at the outset with their expected recovery amount.

The IAS 39 accounting is directly analogous to a cartoon character that runs over the edge of a canyon or cliff, gets a long way out without falling, then looks down, by which time it is too late. The creditor protection provisions of the Companies Act Accounting Rules (that IFRS excised) are the equivalent of a warning sign before getting to the edge in the first place.

The processes of the ASB

I concluded after the May UITF meeting that the ASB has had confused objectives and as a result had made a series of errors in 2003/2004 and has continued with those in place:

- firstly in **not identifying** the problem when IAS 39 was being endorsed by the EU, the ASB supported IAS 39 **intact** despite continental European opposition to it (see below);
- secondly in not then having a mechanism to correct it when in place, i.e. to advise preparers and auditors when it might not work and need to be overridden; and
- thirdly in **copying the defective parts** of IAS 39 into UK-FRS 26.

The first two omissions applied to all banks, IFRS was applicable from 1 January 2005. The third extended the problem to other companies. FRS 26 was applicable for UK listed companies (including holding companies) from 1 January 2005, and for all other UK Companies applying FRS, from 1 January 2006.

This table shows the applicability with the implementation effect shaded.

<table>
<tr><th rowspan="2">UK Companies</th><th rowspan="2">Listed group accounts</th><th rowspan="2">Listed holding company accounts</th><th rowspan="2">Non listed group accounts</th><th colspan="2">Non listed entity accounts, whether holding companies, companies, or subsidiaries.</th></tr>
<tr><th>Banks</th><th>Non banks</th></tr>
<tr><td>1 Jan 2005</td><td rowspan="2">IAS 39</td><td rowspan="2">IAS 39 for banks
FRS 26 for all others</td><td></td><td rowspan="2">IAS 39</td><td></td></tr>
<tr><td>1 Jan 2006</td><td>FRS 26</td><td>FRS 26</td></tr>
</table>

The heavy shading is where the compulsory use of IAS 39/FRS 26 directly upsets company solvency**,** as it is UK legal entities that have to comply with the Companies Act, i.e. it is in breach of the Act requirement for companies not to comply with the solvency rules. The audited accounts are the way of testing that compliance.

The lighter shaded area is where it is the group accounts that are affected ("groups" do not pay dividends, companies do, groups are merely a collection of companies). However, UK Accounting Rules and Standards have always applied globally to subsidiaries in order for them to be consolidated to the same standard as applies to UK incorporated companies. By setting standards to apply to subsidiaries, the very process of consolidation under the Companies Act is requiring the same rules throughout the whole group irrespective of territory even if individual subsidiaries may not be required to be solvent overseas. The Companies Act requires UK companies to be solvent, and requires that to be demonstrated.

The Companies Act is and always has been extra-territorial. That reflects London in particular as a mercantile outward looking business centre and financial centre with assets overseas under UK registered holding companies.

The effect of this can be summarised for the different elements that form a UK banking group, the UK holding company and the subsidiaries.

<table>
<tr><th>Accounts and solvency</th><th>Companies and entities. Are they solvent and profitable in fact?</th><th>UK Companies Act group accounts, do the accounts show the facts?</th><th>IAS 39/FRS 26 accounts</th></tr>
<tr><td>Holding Company</td><td rowspan="2">Solvency position is required by Company Law, i.e. the law requires the fact of solvency, and for it to be shown by the accounts</td><td rowspan="3">Solvency position applies globally as the rules are extra-territorial, and Bank of England (and then FSA) banking regulatory model depended on it. i.e. even if there are not requirements to be solvent or show solvency, the Companies Act reporting model picks it up.</td><td rowspan="3">Solvency position no longer covered (from either 1 January 2005 or 1 January 2006 (see above), as the standard is faulty.</td></tr>
<tr><td>UK subsidiaries</td></tr>
<tr><td>Subsidiaries non-UK</td><td>Solvency provisions may not exist locally outside of UK</td></tr>
</table>

If the banking subsidiaries are in a regime that does not have solvency/stewardship requirements in law or accounting requirements to show it, the accounting provisions of the Companies Act still pick up numbers that are reliable enough to show it.

The Companies Act regime is stewardship from the bottom up, each legal entity has reliable accounts for those directors to discharge their duties, and then pay dividends up and then be reasonably sure that they are solvent. This model of solvency and assurance passes up the group, so that holding company directors can rely on the stewardship of what is going on beneath them, then at the end of all of that, the outside shareholders (who are shareholders of the holding company), get the comfort they are entitled to.

If the UK accounting standard setter gets a standard wrong by missing out a fault with IFRS, or sets itself a standard that positively upsets group wide solvency objectives (as with IAS 39), the problem will be global. The impact in a complex banking group could be like solid foundations turning to jelly. Because they are “numbers” to most people, people may and will take false comfort.

Subsidiaries could appear profitable, and pay dividends up even though they were making losses and were insolvent, holding companies would be relying on that, indeed financing subsidiaries on the basis that they were profitable and growing.

Hence the impact of IAS 39/FRS 26 to a UK registered holding company could very easily be serious, and absolutely catastrophic when it is a banking group. Essentially an accounting engineering system in the Companies Act to firewall companies to protect the creditors of each company could be changed into the financial equivalent of open access. The UK taxpayer was particularly vulnerable to that. The accounting firewall had meant that the Bank of England had only had to stand behind UK limited liability banks, but with “open access”, the problem was global. The FSA’s approach to “living wills” is reconstructing some of that again.

France did not use IFRS for parent company accounts, as a result the integrity of the group is assured. By way of example Crédit Agricole SA, Annual Report and Accounts, page 375.

“Crédit Agricole S.A. prepares its financial statements in accordance with the accounting standards applicable to banks in France.”

“Crédit Agricole S.A. also books reserves on the liabilities side of the balance sheet to cover customer risks that are not individually allocated to loans, such as sector reserves and reserves calculated based on Basel II models. These reserves are designed to cover identified risks for which there is a statistical or historical probability of partial non-recovery against loans classified as performing or not individually impaired.”

All of this is disclosed and audited (page 368 of the Annual Report and Accounts).

The French holding company accounting model, is not IFRS, and is more like the sound construction of the Eiffel Tower. In comparison to that, UK and Irish banks using the rules of IAS39/FRS 26 is more like the Leaning Tower of Pisa (without even the recent stabilisation works). If some of the energy put into criticising the French due to their dislike of IFRS, had been put into actually reading a set of French accounts, both the IASB and ASB may have come up with different, more informed conclusions.

Parliament - which set the law and doubts about the ASB

Parliament was concerned about accounting standards after Enron. The Treasury Select Committee, after Enron, said in its report[56]:

- “Pressures to agree a comprehensive range of Standards by 2005 must not dilute standards applicable in the United Kingdom, particularly in relation to a 'true and fair' view.”

[5] http://www.aviva.com/media/our-view/2683/ Statement from AVIVA Investors (one of the largest UK investment firms)

[6] http://www.publications.parliament.uk/pa/cm200102/cmselect/cmtreasy/758/758.pdf (The Financial Regulation of Public Limited Companies, 2001-02)

- "We asked the ASB about the implications of insufficient international standards being in place by 2005. Its Chairman expressed the view that there was a risk that the price of agreed international standards might be that they were of lower quality than apply in the United Kingdom. She added "We at the ASB have as our number one priority ... to work with [the] IASB to try to minimise that risk and to make sure that the financial reporting solutions for UK companies come 2005 will be every bit as strong...".

- "We were disappointed at the leisurely approach of the ASB. We believe that there are issues for the Board that require action before 2005."

So Parliament was picking up problems then, and there were problems with the way that IFRS was being constructed:

> "One of the things we often say is, when countries like those in the EU took IAS standards, they did so with great courage – and total ignorance of what was in them." To get IFRS in shape for the new deadline, "we really had to go in and cut-and-paste and improve." Bits of accounting standards – mostly from the US and British rulebooks – were lifted and rammed into place, while other standards were drafted from scratch and others hastily rewritten. It wasn't easy, it wasn't elegant, but they did it, and the first full-year IFRS numbers started pouring out of European companies in January 2006."
>
> Sir David Tweedie, Interview in Financial Director Magazine, 26th March 2008

The IASB's own problem of process with "incurred loss" when the consultation implied "expected loss" (the opposite) is some evidence of that. The impact on capital and profits could not be more different.

Accountability for the problems with IAS 39

Having flagged problems at a UITF meeting in March 2010, with the flaws on IAS 39, the problem was not denied, but I was given the answer that "EFRAG[7] had endorsed it". That's as may be, but EFRAG does not set standards for UK non-IFRS companies, nor does EFRAG set standards for solvency purposes. By the way that UK law is constructed for UK companies (and for subsidiaries of UK registered companies) the ASB is still responsible for standards implementing the solvency objectives of the Act**.** There is therefore a question as to whether the ASB does really understand what it should have been doing and should be doing. Some standard setters have even said that the law (of solvency and creditor protection) needs to be changed. That is not a reason for applying the law. This is particularly true if companies coming under that legal requirement to have audited accounts showing solvency and capital include banks.

If an EU endorsed IFRS standard is inconsistent with the functioning of Company Law, the UK would have a major problem if it was not corrected. As occurred.

Despite problems with IAS 39, with some EU member states not liking it when it was up for EU endorsement, the ASB rather than identifying problems was positively **campaigning** for it.

[7] EFRAG – is the EU body that endorses IFRS for the EU, where they become EU-IFRS and law for reporting purposes.

Given the importance of financial services to London, that might have had a copycat impact, other far smaller member states might assume that the ASB was sufficiently proficient to be sure that IAS 39 (and IFRS) was suitable for the UK, hence support it on the basis that the ASB could not be wrong[8].

In conclusion, then, we agree with your assenting members that the widespread introduction of IAS 39 will strengthen financial reporting in Europe.

ASB letter to EFRAG dated 10 June 2004

The IASB proposed in its exposure draft that the revised IAS 39 should incorporate a significant amount of new material on loan loss provisioning. Unfortunately, it was not clear from the exposure draft whether the IASB intended entities to adopt an incurred loss approach or an expected loss approach. At the roundtables the IASB explained that it had meant to require an incurred loss approach. It intends to clarify this in the final standard.

Inside Track (news sheet) – ASB April 2003

Problems in thinking from changing words

I believe that some of the muddled thinking of the ASB can be seen in the very title of this proposal "Financial Reporting", i.e. presentation.

The Companies Act requires Accounting Standards to do two things:

1) check the support of the financial infrastructure (like the core of a bridge)
2) then report outcomes (like the paint on a bridge, what the people can see)

The ASB, in consistently "eliding" its objectives from an "A" to an "F", from "Accounting" to "Reporting", is overlooking the first and systemically far more important function.

Whether a dividend is able to be paid is a test on which the law relies on accounting standards under that law. The very implication of "Financial Reporting" is ex-post, i.e. the accounting standards are only reporting on things that have happened.

The ASB and the loss of the true and fair view – what is a true and fair view?

As Parliament identified after Enron, "true and fair view" clauses in the Companies Act were a safeguard in the event that accounting standards were faulty, i.e. the true and fair view went beyond compliance. However, when the IAS regulation was implemented in UK Company Law in 2004 for 2005, in order to feather IFRS into the Companies Act 1985, the new clauses stated that a true and fair view was the result of applying the standards, the opposite of what the true and fair view was. The error was repeated, not only for IFRS accounts, but Companies Act accounts as well. The ASB will be aware that the error resulted in direct ministerial intervention. The error was corrected in the Companies Act 2006, but the relevant clauses were not invoked until 2009, as the Act was implemented in stages. The error was spotted by the three main UK investor groups IMA/NAPF/ABI. None of the constituent parts of the FRC, including the ASB, identified the error.

[8] Letter from Chairman of the ASB Mary Keegan to EFRAG 10 June 2004, ASB.

When I questioned at a UITF meeting in 2010 whether the ASB might have got its own standards wrong (the ASB had copied IAS 39 to produce ASB-FRS 26), i.e. the accounts might not give a true and fair view for the purpose of the Act, I was given the long standing legal opinion from Mary Arden QC. In short, this states that outputs of the ASB would generally be evidence for a court that the accounts would comply with the accounts preparation requirements of the Act. The advice does leave it open that it might not, it is not carte blanche. The Arden advice does not assume that the ASB might be setting a standard for only a superficial presentational purpose that does not actually met the purpose for which they are to be prepared for, the ASB is essentially setting quasi secondary legislation, and to do that properly it must abide by the objects of the primary legislation and know what that is. Neither IAS 39 nor FRS 26 does that.

Despite IAS 39 being directly at odds with the law (and being a factor in the collapse of at least 3 major banks) the ASB continued to defend incurred loss provisioning, until as late as March 2009[9]. The FRC and ASB convened a semi-public meeting to discuss the issue. The ASB did by then realise that there was a problem with incurred loss, the problem was also emerging in Building Societies far from London. The ASB/FRC proposed an "economic cycle reserve", that was not the responsibility of auditors. All of the auditors at the meeting (bar one) spoke for incurred loss provisioning on the basis that "users" supported it. I asked at the meeting whether "users" liked to see banks collapsing, i.e. it is possible to make money from shorting shares. It is a fault of the relativist "useful for users" rather than relevant for the capital maintenance approach that preceded IFRS.

Of all the regulators, only Lord Turner, a non-accountant, saw that the economics did not work. He was essentially re-establishing the case for prudence which had been thrown out by the standard setters.

This was the press statement that was put out, after that FRC/ASB meeting to address Lord Turner's conclusions.

> *"An ECR would be built up during the upswing of the economic cycle through an appropriation from retained profits. It would be an undistributable balance sheet reserve, limiting a bank's ability to pay dividends and make share buybacks during the upswing and available to be released in the bad times. It is a "rainy day" provision".*
>
> *"there is support for economic cycle reserving if it is agreed between the bank and its regulator"*
>
> *"provisions should not be implemented in a way that impacts the P&L of a company"*
>
> **ASB PN 340, 19 March 2009 – ASB press statement on incurred loss provisioning**

The statement itself is revelatory of two things:

- not understanding the law (as accounting standards should already constrain dividends)
- neglecting economics and risk to deliver the law

[9] http://www.frc.org.uk/asb/press/pub1900.html

Under law, restricting dividends was already the expected function of an accounting standard, to deliver to the standard of Section 837, because to control dividends, profits needed to be safe to state. Further, in order to see whether lending is profitable, the cost needs to be reflected in the profit and loss account (not merely reserves) so that the lending margin is true. Only that way is it possible to project a trend loss. The ASB statement was in fact proposing "reserve accounting for losses" something most people would regard as an abuse (Polly Peck plc collapsed largely due to that).

It still took a considerable while for the ASB and IASB to conclude that the incurred loss model overstated profits and assets, obscured the trend destruction of capital and the current lack of it. There were only 3-4 people at the meeting who spoke up for "expected loss" (the model that the UK had had from 1879-2005), the ASB was actively lobbying for the opposite, and in the event that it did come in, to take it out of the purview of the auditors.

Just because an item is difficult to estimate does not mean it should be avoided, the insurance industry would not produce any accounts on that basis. The ASB muddle is causing problems for mre companies than merely those that are banks.

Rights issues also rely on proper accounts to work properly

The framework of Company Law is progressive from annual accounts to rights issues:

- **annual accounts** – as described earlier, prevents creditors and long-term shareholders being disadvantaged by the management or shareholders, then,
- **prospectuses** - take audited annual accounts ("stewardship" based), and then look in more detail at contingencies, risks and events. The purpose of this is to protect incoming shareholders from overpaying due to a "false" prospectus. This enables subscribers to appraise the business plan, the **reliable** balance sheet and all the risks.

It is quite clear that the IASB and ASB were keen for the EU to allow IFRS to serve a "combi function" for **both purposes**. However, the lack of proper annual accounts actually makes both of the above functions fail. There appears to have been an odd symbiosis between EU officials who do not understand capital markets, and accounting standard setters who do not either.

The IFRS for SMEs is not serving a creditor/protection stewardship function, but compliance

The project history of the IFRS-SME states that the IASB decided that it was **not** the purpose of the IFRS-SME to be used for assessing tax (i.e. making a distribution of **profits** at the pre tax level) or dividends (i.e. making a distribution of **profits** at the post tax level).

That is contradictory to what Parliament has set out that accounts are for and which was re-decided as recently as 2006 with the introduction of the new Companies Act. The IASB has set the IFRS-SME on the basis that the **objective** is to provide information of a quality that is "useful to users". This is a very subjective, if not woolly, objective. This raises at least 2 questions about the impact of IFRS-SMEs:

- What use is IFRS-SME if the **profits** are not a reliable base on which to distribute dividends (or tax). Essentially, what's the point if the pre and post tax **profit** number is not reliable? Who are the users on that basis?

- Given that the IFRS-SMEs is intended to be used for private companies, what is the benefit to them for that purpose? Commonsense would say that dividends and tax are important to SMEs otherwise they will need "two sets of books", to prevent them from becoming insolvent.

If profits are not reliable paying for dividends or taxes, the problem moves further up the profit and loss account. Not only are accounts using IAS 39 unreliable for making distributions of dividends and tax, but they are also unreliable for paying employees, in fact even lending, as the accounts may be showing false profits in what may already be an insolvent bank, or a bank heading to insolvency which should not be lending at all.

Accounts that are not reliable for companies paying taxes have another impact as well. The government receiving taxes should have an interest in taxing real profits not false ones, as tax revenues will dry up if profits suddenly reverse. Indeed tax revenues may dry up at precisely the same time that governments are required to step in to refinance banks.

> The IFRS for SMEs says:
>
> *Distributable profits*
>
> 44. Companies making distributions of income to their shareholders must make them from distributable profits. It is therefore sometimes argued that, if users are to have a proper understanding of the level of sustainable dividends and of the prospects of dividend growth, it is important that the level of distributable profits is reported and that dividends paid and payable are reported in the context of those distributable profits.
>
> 45. However, in practice – and particularly for a group – the potential for distributions, whether from profits or return of capital, is dependent on many factors, including company legislation in the countries in which the operations are carried out, corporate structure, currency and dividend controls, and the entity's financial adaptability. In these circumstances it is unrealistic to suppose that distributability per se can serve as a primary focus of the presentation of financial performance.

All I can say to that is that I was taught to identify the difference between a reason and an excuse.

It has sometimes been said that there is "an expectation gap" about audited accounts (auditors not finding fraud). The proposed IFRS-SME changes the purpose of accounts considerably and in terms of eliminating creditor protection can only make any existing expectation gap worse.

One major irreconcilable difference between IFRS' approach and Company Law is simply this: the Companies Act is trying to prevent creditor abuse, the SEC is not. It could be said that the Companies Act is trying to prevent "junk equity" (to protect creditors), the SEC is allowing anything to be traded without that quality test of the company in corporate form, so junk equity can be traded just like junk bonds. The Companies Act is trying to prevent junk equity at source. The Companies Act uses accounts and information for driving proper financial governance. The SEC model requires a form of governance – essentially process - for "correct information", it is a model of compliance, and of late clearly has not worked. It assumed that markets naturally self-regulate, but they never will when companies have the insider advantage of limited liability.

The concept of an auditor "expectation gap" started in the USA. However, on having UK Section 837 explained properly, the concept of an expectation gap diminishes somewhat. Material fraud is relevant to whether the auditors can conclude properly on paying dividends. The experience of compliance driven IFRS has been that **risk** has become the new expectation gap, as the accounting left risk out, covered it up, and in many places positively incentivised it. It is leaving out stewardship, and the disappearance of prudence as an overriding principle is a symptom of this underlying failing.

FRS 26 (the ASB copy of IAS 39) causes problems beyond the financial sector

FRS 26 as it applies to all listed holding companies creates another hazard that applies to all listed companies whether they are engaged in financial service activity or not. The incurred loss principle of IAS 39 is also in FRS 26, and includes the way that companies should assess their intercompany loans, i.e. amounts lent from one subsidiary to another.

That creates a further particular hazard in that not only might external lending be overstated giving rise to insolvency, but also that intergroup lending might be overstated giving rise to a hidden insolvency within a group (the EHR/Farepak problem was like that) which then falls over. The EHR insolvency emerged when the bank refused to fund an overdraft, the reason being that the bank could assess that the Farepak loan to EHR was not worth that much anymore being lent to a parent company that was a "man of straw". Companies Act accounting is supposed to do that, IFRS does not.

Situation	Companies Act Accounting Rules	IFRS/FRS26
Holding company: **Lends to subsidiary**	The accounting rules require assessing the holding value at all times prudently.	The accounting is incurred loss provisioning (**waiting for default stress to occur)**.
	then:	
Subsidiary uses the money lent for its business purpose	The accounting rules for any subsidiary require the subsidiary accounts to show solvency (capital or lack of), i.e. the accounts show the state of the investment.	The subsidiary if using IFRS is not necessarily showing insolvency (losses or lack of capital).

The impact of defects already in the system

Prior to IAS 39 and FRS 26, any finance director who did things required by them of his own volition would most likely be held to be negligent and reckless. A company may very quickly become insolvent if it is making hidden losses. For directors, trading whilst insolvent is a criminal offence. If faulty accounting standards are sanctioning or even fostering insolvency, then the crime (insolvency) is covered up by what is legal (compliant accounting by the standards) but is still a crime and is still not absolved. With faulty accounting standards two parts of law will clash, IFRS is faulty compared to the law of insolvency as IFRS has got faulty short-term economics embedded in it.

Whatever occurred or did not occur in 2004, the defects with IAS 39 have now been known about for well over two years. To my knowledge, the ASB has not attempted to resolve the problem for existing FRS 26/IAS 39 by suggesting appropriate corrective measures.

If the ASB is not withdrawing parts of its faulty standard is BIS (formerly the DTI), which prosecutes insolvency cases, going to be giving dispensation to directors who are using it in good faith? The ASB has issued no guidance on that extremely hazardous defect, despite banks and non-banks having collapsed, appearing healthy one day by their accounts and not the next. These defects have been known about for well over a year. Nor has the ASB attempted to resolve the problem for IFRS using companies by appropriate corrective measures.

The Cause and Symptoms of Dysfunction and Regulatory Drift

Problem/Symptom	Accounting Issue/Cause
Banks & Regulation	
FSA is doing stress tests of banks	IFRS is not a stress test, but Company Law requires it for all limited companies
"Bankers pay is out of control"	IFRS produces false profits on which performance is rewards
Banks needed emergency injections of capital	IFRS produces false profits and false capital
Government/Treasury	
UK has very large deficit	IFRS produces false/cyclical profits which were taxed, but then dried up/reversed. UK has a very large financial sector, and Government has had to inject capital into major banks, and undertake Quantitative Easing.
City, Pensions & Investment	
Equity returns since 2005 have been nil or negative	The IFRS accounting standards model is not focussed on creating wealth, or distributing it properly. It is based on "efficient market theory". A doubtful theory at the best of times, but markets will be very efficient if people are incentivised to do the wrong things (Enron)
Confused policy making	With IFRS the numbers are wrong, that impacts on every policy area. Even GDP growth numbers may be false.
Pay is out of control	IFRS has "profit" as the difference between two market volatile balance sheets. That gives management an option on the profits, and they can walk away from the losses (there is no "malus", the opposite of a bonus). To work IFRS would need a "malus" system to try to counteract its cyclicality.
FRC consulting on investor stewardship	IFRS has excluded stewardship at banking company level, meaning even directors are unable to do stewardship properly to the subsidiaries that they own.

Problem/Symptom	Accounting Issue/Cause
Collateral Issues	
IFRS is complex	It is not based on business rules that people can understand. It is based on "efficient market theory". Further the IASB set standards by compromise and tried to keep-up with what investment banks were doing. The problem of relativism rather than setting boundaries. "Generally Accepted" = "Absolutely Degraded".
IFRS at best requires "two sets of books"	Two sets of books is a breeding ground for corruption and mistakes.
Accounting standards consultations are an industry of their own	IFRS is a "user model", it is arbitrary moving all of the time. Accounting Rules were in the Companies Act. Other than accounting firms, the biggest funders of the IASB were investment banks.
Corporate governance is burdensome	The IASB has created a model of corporate governance for reporting, rather than financial governance flowing from having proper accounts and accountability.
FRC is consulting on "complexity project", but then suggesting even more words.	The accounting standards are coming up with the wrong numbers.
Business people do not like accounting standards	Key accounting standard setters are full time, and not independent of that job.
Accounting standards setters supported "efficient market theory".	Full time standard setters that have got things wrong on that theory and have limited rent outside of that (see governance above). .
FRC-APB is consulting on "auditors and scepticism", because FSA has found fault with the audits of some banks.	IFRS has not hardwired prudence into the accounting system (it has been taken out). The FRC inspects on a compliance with standards (auditing and accounting) model. If the model is flawed the FRC will be sanctioning sub-standard legal discharge.
EU has endorsed faulty standards	EU process tends to be led by lawyers from countries with small, if any, capital markets. Due process not outcome. EU has been advised by standard setters. A circularity at best.

Problem/Symptom	Accounting Issue/Cause
"The French do not like IFRS"	The French will not be susceptible if a form of 'group think' has been instilled by using woolly interpretations in the English language, for principles that are intellectually unsound.
G20 politicians have needed to discuss accounting standards	Accounting standards have tended to be set with a degree of "regulatory capture", the USA's accounting industry's desire for accounting standards that limit duties and achieve "compliance" have coincided with the short term interests of US investment banks in particular.

RESPONSES TO QUESTIONS

1 Do you have any comments on the overall direction of travel for the UK Financial Reporting Framework as described above?

As covered earlier, I believe that the ASB is now *ultra-vires* in assuming it merely has a “Financial Reporting” standards function, when in fact it has a function that is beyond that and better than that. The IASB is setting non-jurisdictional standards, i.e. no particular law applies. However, the ASB does have jurisdictional responsibility (for the UK and Ireland), but it is copying from IASB standards, without adjusting for the fact that it have a jurisdictional function. The Companies Act is not merely a financial reporting framework, it is an accounting framework for dividends, capital maintenance, solvency and other things. That has always been the case; it is about self-assurance as well as third party information. It is an accounting/governing/reporting model. The ASB, in getting that wrong, is not making the FRC look like an effective regulator of governance and reporting. It is like a doctor giving a patient blood of the wrong group.

Another impact of the ASB leaving things out, is to put the FRC back to front objective-wise. The FRC’s governance role only covers listed companies. If the problem is replicated in to the non-listed sector, the impact would be very serious. “Financial Reporting” is now a serious factor in quality people no longer wishing to be NEDS. “Financial reporting” alone as an objective is rather contrived. And what is done off that is not an audit. It merely seems to be a way getting others to do the auditors work for them, whilst maintaining the statutory compulsion of audited accounts, but when the reason for the compulsion - creditor protection - is left out. The ASB perhaps is confusing:

- Governance <u>for</u> reporting (process and committees, a bureaucracy)
- With governance from accounting/governing/reporting model.
  (Hard numbers and facts from “kicking the tyres properly.”)

2 What do you think the overall impact of the proposed UK Financial Reporting Framework will be in terms of its likely costs and benefits – quantified where possible? In framing your answer you might like to consider the following:

a) the impact on the economy as a whole, efficient functioning of markets and enterprise, fostering investment;

The ASB uses the term market in a very loose way. The Companies Act addresses a corporate life-cycle, formation, AGMs, solvency, capital maintenance, and winding up. Then, there are capital markets.

The concepts above do not translate at all well to many entities that prepare accounts and have audits for director/shareholder/trustee/mutual/creditor assurance

The words “efficient” and “fostering” are somewhat pointed. There is no question pointing to disadvantages or risks. The main-IFRS experience has coincided with absolutely dysfunctional markets. I have explained how the existing framework of UK GAAP supported an outward investing model of ownership and control, and the faulty and arbitrary “for users” objective has led to financial catastrophe and banks collapsing.

The main IFRS also has had an intellectually unsound basis “reduce the cost of capital”. The reason for Companies Act accounts, and then the prospectus rules, is to get the right amount of capital and to see the return from it. In the case of prospectuses that there is not a value transfer from incoming capital to existing capital, and in the case of annual accounts an unfair value transfer from creditors to shareholders. A low “cost of capital” can actually be market and shareholder/creditor abuse, i.e. the share-price in the short run is too high. Banks had a very “low cost of capital” in the first years of IFRS, due to risk mispricing due to IAS 39. Thereafter the “cost of capital” was enormous (credit default swaps of hundreds of basis points).

I question the economic grounding of the ASB in phrasing some of these questions without really thinking about the words.

b) *transition to the new framework, noting that for entities currently applying the FRSSE there will effectively be no change;*

This again seems to be a wholly pointed question. The term “effectively no change” is not the same as no change, and the proposals in a practical sense put the FRSSE in as only a transitional measure.

c) the impact on groups of the proposed reduced disclosure framework for subsidiaries;

This again, misses the point of why subsidiaries have accounts. Given that the ASB is missing the fundamental relevance of accounts, it is impossible to ascertain whether the issue of “reduced disclosure”, is good, as the question implies, or bad.

The reason that Parliament has legislated is to protect the interest of those shareholders (where there may be minorities) and creditors. Subsidiaries can move in and out of groups, or stand alone. The subsidiarity in being a subsidiary does not alter the rights of creditors/shareholders or the obligations of directors of an entity. Again, this is a result of the premise starting from the wrong place.

d) requirements for education and training of account preparers and users, and the impact on their intellectual mobility;

The term “intellectual mobility” is jargon *par excellence*. Is it saying that “full IFRS is so complicated only professional analysts can understand it”? If, so it begs the question, why? And why is a model justified for listed-capital markets being used outside of that environment?

e) whether the information available to users will be more useful for investment decisions, and by owner-managers in managing their businesses, than the existing framework.

This question again betrays a lack of knowledge of the law, and again is pointed towards information being “more useful” which is a contrivance. Owner managers use management accounts for day to day decisions. Audited accounts <u>discharge</u> the duties of director to make distributions etc within the law. They are a health check, not marketing brochures. Accounts that in fact show bad things, might be very uncomfortable for the parties involved. Again the question is assuming positive outcomes not controlling bad ones. It is missing the point of the statutory discharge function of accounts.

3 What do you think would be the impact if the ASB were to propose increasing the scope of the FRSSE to include larger entities (for example, to include all medium sized entities, or to use an alternative size criteria)?

This question seems to be implicitly suggesting that the ASB is now uncomfortable with proposing full IFRS or IFRS-SMEs.

4 What do you think the impact of the proposed UK Financial Reporting Framework will be on taxation and distributable profits?

Given that the IASB board has positively stated that the standard is not seeking to be reliable for that objective it can only be a fundamental problem. The impact can only be paying inappropriate amounts in tax and inappropriate amounts in dividends, it is the inevitable product of accounts designed to be unreliable!