

**Accountancy and the Banking Crisis: Some comments on the Treasury  
Committee's request for Information**

**By**

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I am delighted to provide some information for the Committee's consideration.

**The purpose, and intended audience, of financial accounts**

To say that the current financial reporting system is in a mess would be an understatement. The financial reports are primarily aimed at meeting the assumed needs of investors and creditors, or capital markets. The current financial crisis must cast severe doubts about such idealised claims. It is assumed that the same reports can also meet the needs of other stakeholders. This is simply not true. For example, bank depositors may be concerned about excessive risk-taking by banks. There is little information about risks in financial reports. Profits can be from investments of varying degrees of risks. Yet there is no disclosure to shed any light on this. Similarly, employees may be concerned about job security, which may be dependent on investment in research and development, management of risk, creativity, new products, orderly liquidation of older assets, liabilities and products and their replacement by newer ones. But such information is rarely evident from financial statements. In short, the needs of other stakeholders are neglected in financial reporting.

There is also a vast gulf between the aims and objectives assigned to financial reporting by standard setters and those advanced by courts. For example, the IASB/ASB claims that the objective of financial statements is to enable investors and creditors to make predictions of future cash flows, earnings and performance. However, possibly fearing a backlash from their financial sponsors, the IASB/ASB do not require companies to publish budgets, forecasts, plans or anything else that might provide clues about future cash flows, risks or earnings. Such information is also needed by regulators.

The IASB/ASB financial reporting objectives are far removed from the focus on stewardship. The Companies Acts seem to support a very narrow basis of financial reporting. The judges in the 1990 House of Lords judgement in the *Caparo*<sup>1</sup> case noted that

“There is nothing in Part VII [Companies Act 1985] which suggests that the accounts are prepared and sent to members for any purpose other than to enable them to exercise class rights in general meeting. I therefore conclude that the purpose of annual accounts, so far as members are concerned, is to enable them to question the past management of the company, to exercise their

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<sup>1</sup> *Caparo Industries plc v Dickman & Others* [1990] 1 All ER HL 568

voting rights, if so advised, and to influence future policy and management. Advice to individual shareholders in relation to present or future investment in the company is no part of the statutory purpose of the preparation and distribution of the accounts<sup>2</sup>”.

The above cannot easily be reconciled with the IASB/ASB statements. The IASB/ASB statements do not seem to be promoted by auditing standards either. There is an urgent need to resolve the contradictions in the objectives of financial reporting. Auditing and accounting interpretations of the objective of financial reporting cannot easily be reconciled. One of the *Caparo* judges also added

“I find it difficult to believe, however, that the legislature, in enacting provisions [Companies Acts] clearly aimed primarily at the protection of the company and its informed control by the body of its proprietors, can have been inspired also by consideration for the public at large and investors in the market in particular”

The Companies Act is the prime authority for publication of financial statements, but it is not designed to protect the interests of investors. The financial statements do not advance the interest of bank depositors, borrowers, employees and other stakeholders. There is an urgent need to revise the Companies Acts. The objective of financial reporting should be amended by the due process of law and parliamentary scrutiny rather than through the private processes of the IASB.

The standard setters also seem to think that almost everything can be valued and measured. This is simply not the case. There are considerable difficulties in valuing assets in thin or relatively inactive markets. The collapse of Long Term Capital Management<sup>3</sup> (LTCM), a hedge fund, and its rescue in 1998 by the US Federal Reserve showed that even the Nobel Prize winners in economics had difficulties in valuing derivatives or complex financial instruments. It is doubtful that accountants or company executives have a superior know-how. An alternative is to disclose qualitative information about such securities, but the IASB/ASB has not pursued that route.

The IASB/ASB seems to believe that financial reports should somehow replicate the market and thus provide investors and creditors with an approximation of market values. This is impossible. Financial statements cannot do this because their contents depend on whatever the contemporary conventions, prejudices or power structures permit. Some thing may confer economic advantage or disadvantage but because contemporary accounting rules do not recognise it, it then remains unreported. Put simply, accounting standards are simply the residue of political negotiations and bargaining amongst corporate elites. Whatever is left is promoted by the IASB/ASB as objective or neutral. Yet it is none of that. Standards are merely being manufactured to advance some worldviews and interests.

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<sup>2</sup> [http://oxcheps.new.ox.ac.uk/casebook/Resources/CAPARO\\_1.pdf](http://oxcheps.new.ox.ac.uk/casebook/Resources/CAPARO_1.pdf)

<sup>3</sup> Dunbar, N. (2000). *Inventing Money: The story of Long-Term Capital Management and the legends behind it*, New York: Wiley.

Accounting standards are actively involved in transfers of wealth, income and risks and should be formulated by agencies that represent a plurality of social interests. Yet that is not the case with the IASB or the ASB.

### **The role that fair value accounting has played in the banking crisis, and whether any change to fair value reporting rules and requirements is appropriate.**

There are two major issues. What is the purpose of financial reporting? The IASB seems to think that accounting should replicate markets. This is highly problematical and not really possible.

The second problem follows from the first. If the 'market' value approach is to be followed, then there are difficulties in that many markets are thin and simply do not provide reliable prices. Some assets are very business specific and are not easily amendable to free market prices. The value of some depends on some events. The final outcome of a complex contract (e.g. derivatives) will not be known until the date of expiry. Anything prior to that is just a guess and bound to be uncertain. The IASB also allows companies to build their own models and follow what has popularly become known as 'mark to market'. The inappropriateness of these models was highlighted by the Enron scandal and resulted in misleading information.

In the light of these problems, the IASB should first test its propositions and also note their possible adverse consequences.

### **The role and accountability of the International Accounting Standards Board**

The IASB has no democratic mandate to transfer income, wealth and risks. It has no moral mandate for making regulations. Right from its birth, avoidance of taxes and hence accountability was a major factor in its operations. The official story of birth<sup>4</sup> notes that the Foundations controlling the IASB "should be organized so that contributors could obtain tax relief on their contributions and that the Foundation not be taxed on the contributions received on any interest or other investment income it receives" (Camfferman and Zeff, 2007, p. 240). The foundation controlling the IASB is registered in Delaware, a place well known for secrecy. In my view an organisation which is formed to avoid accountability cannot have any mandate to make regulations for others. As the article below illustrates, the IASB's policymaking apparatus is available for hire to the highest bidder.

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<sup>4</sup> Camfferman, K. and Zeff, S.A. (2007). *Financial Reporting and Global Capital Markets: A History of the International Accounting Standards Committee, 1973-2000*. Oxford: Oxford University Press.

The following brief article<sup>5</sup> articulates some of the concerns about the IASB operations, funding and policies.

One of the disturbing things about modern globalisation is the privatisation of public policymaking. All over the world, public regulation is moving away from public bodies and elected governments and towards private and unaccountable cartels. A good example of this is the London-based [International Accounting Standards Board](#) or IASB, which formulates accounting standards that affect the financial reporting of all companies quoted on European stock exchanges.

The IASB claims to advance business accountability and transparency, but is itself a highly secretive organisation. It is the offshoot of a private company registered in the US state of Delaware, a place well known for corporate secrecy. It is funded by the "big four" accounting firms - PricewaterhouseCoopers, KPMG, Deloitte & Touche and Ernst & Young - and major corporations. The same interests dominate all its structures and committees. Many accounting trade associations, including those from the UK, have signed-up to the IASB, as they seek to advance the narrow interests of their members and keep public accountability at bay.

The self-congratulatory annual reports of the IASB did not reveal this, but the fallout from the collapse of the US energy giant [Enron](#) showed that the IASB had solicited a contribution of \$500,000. Enron executives considered this request because they thought it might help them to influence accounting rulemaking. US Senator Carl Levin, chairman of the permanent subcommittee on investigations, said that the correspondence showed "Enron wanted to know whether its money would buy access and influence ... and its auditor didn't bat an eye at this inquiry."

Paradoxically, auditors claim to independently enforce accounting standards, but here they are in bed with corporate interests and control the production of the same standards. This is further proof that auditors cannot deliver independent audits.

The collapse of Enron and WorldCom drew public attention to organised tax avoidance. Major [accounting firms](#) and [companies](#) continue to be mired in tax avoidance. Yet the government does not require companies to publish details of any tax avoidance schemes or even how much tax, if any, they pay in each country of their operations.

It is claimed that the IASB's [accounting standards](#) are based on principles rather than detailed rules. This is a myth. The IASB accounting standards cover over 3,000 pages. Even a Kremlinologist would be hard pushed to find

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<sup>5</sup> Sikka, P. (2007). There's no accounting for accountants. *The Guardian* (Comment is Free), 29 August, ([http://commentisfree.guardian.co.uk/prem\\_sikka\\_/2007/08/no\\_accounting\\_for\\_accounting\\_s.html](http://commentisfree.guardian.co.uk/prem_sikka_/2007/08/no_accounting_for_accounting_s.html)).

any principles of honesty and social responsibility at play. The simple truth is that accounting rules are the outcome of politics and bargaining amongst corporate elites populating the IASB. The resulting residue is routinely described by the IASB as "neutral" and "objective". These are highly value-laden concepts that nevertheless continue to disarm journalists and critics.

The European Union has capitulated and adopted IASB standards for all quoted companies, without agreeing any rights for the parties affected by them. The US initially resisted, as it did not wish to compromise its sovereignty and concede domestic policy making to a foreign organisation. However, under pressure from corporations, it too is likely to [capitulate](#) in return for a dominant voice on the issues.

The IASB accounting standards affect the distribution of income, wages, dividends, wealth, risks, taxes and social welfare. The standards function in a law-like manner and can be used by the courts to adjudicate claims of improper corporate and executive behaviour. Yet, the IASB is not accountable to democratically-elected parliaments. Its members are not elected by stakeholders or any representative organisations. Neither is their suitability scrutinised by parliamentary committees.

To secure its legitimacy, the IASB has covered itself in garbs of pluralism and a "due process" which invites interested parties to comment on its proposals. Such processes advantage corporate interests who have the resources to shape policies. Ordinary people suffering from dubious accounting and losing their jobs, savings, investments, pensions and homes are not in any position to shape IASB standards. There is no evidence to show that any note is taken of the views of non-corporate respondents.

The victims of poor accounting cannot check the IASB because it does not owe a "duty of care" to any individual shareholder, creditor, pension scheme member or any other party affected by its pronouncements. The details of any Enron-type deals made with financial backers are not on public record. Despite being a de facto public policymaker, the IASB is not subject to "freedom of information" laws.

The IASB expects all major businesses - whether based in America or Afghanistan, Britain or Bolivia - to follow its standards regardless of local needs and histories. The IASB accounting standards are imposed on developing countries as conditions of loans, grants, investments and donations by western governments, the World Bank and the International Monetary Fund. This is part of new colonialism and [ideological domination](#). Such imposition makes developing countries dependent on the west and prevents them from developing appropriate local institutional structures.

In case any countries start developing accounting practices to meet local needs, the [IASB chairman](#) has warned: "We have to nip this in the bud."

The aim of the IASB is nothing less than global domination and to make the rest in the image of the west, fit for major corporations. Ironically, the

accounting standards forced upon developing countries have already failed, as shown by numerous western accounting scandals. They have little relevance to developing countries which do not have or do not need active capital markets and wish to develop alternative ways of corporate governance. For example, the IASB accounting standards do not easily fit [Islamic](#) beliefs, and thus exacerbate tensions.

The IASB project is imperialist in nature and a recipe for domestic strife and international conflict.

## **The process of amending accountancy standards**

The IASB due process is designed to mobilise support for chosen alternatives. It is captured by economic elites and rarely engages with alternative ideas. The issues can be illustrated by the recent debates over IFRS 8 which deals with “operating Segments”.

The background is that most multinational and major corporations publish consolidated financial statements. These are supplemented by disclosures about key segments. The key problem is that IFRS 8 provides no benchmark and leaves the choice of ‘segments’ to management. This is totally inadequate and does not inform investors, creditors, regulators, employees, governments or anybody else.

An alternative to IFRS 8 is an alternative known as the “Country-by-Country-Approach<sup>6</sup>”. It was first drafted in 2003 by Richard Murphy, a chartered accountant, for the Association for Accountancy and Business Affairs<sup>7</sup> (AABA). The problems, as Tax Justice Network (TJN) puts it, are that

“Multinational companies use subsidiaries to shift profits and risks between different jurisdictions – often tax havens – yet current international accounting standards do not require them to publish relevant country-specific information on corporate income, profits, taxes, investments, assets, liabilities (or carbon emissions.) Instead, global standards set by the International Accounting Standards Board (IASB) permit companies to combine results from different countries into a single global (or regional) figure, and it is impossible to use company accounts to unpick these numbers for each country<sup>8</sup>”

It should be noted that banks are currently receiving massive amounts of public money yet have been key players in the tax avoidance/evasion industry, not only dodging their own taxes about also helping their clients to evade taxes<sup>9</sup>. The disclosures advocated by the ‘country-by-country approach’ would have highlighted such activities.

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<sup>6</sup> The document can be downloaded from <http://visar.csustan.edu/aaba/ProposedAccstd.pdf>

<sup>7</sup> <http://www.aabaglobal.org/>

<sup>8</sup> <http://taxjustice.blogspot.com/2008/06/press-release-country-by-country.html>

<sup>9</sup> Sikka, P. (2008). Taking liberties (and tax dollars), *The Guardian* (Comment is Free), 15 September (<http://www.guardian.co.uk/commentisfree/2008/sep/15/creditcrunch.taxandspending>)

The “Country-by-Country-Approach” would require companies to publish a table showing the jurisdictions that they operate from, together with the income, profits, assets, liabilities, taxes, employees, etc. for each jurisdiction. Thus we might find that some banks claim to be operating from a tax haven but have very few employees, or that a company is primarily trading in the UK but pays virtually no corporations tax. It is my contention that such information provides information for regulators and other stakeholders and illuminates corporate operations that IFRS 8 does not.

As the IASB engaged in its ‘due process’ to develop IFRS 8, it received a number of submissions that did not support the relevant exposure draft. Rather unusually, a large number of NGOs wrote to it. It did not listen even though the NGOs appeared to be in a majority. Some of the issues about this episode are outlined in the following article<sup>10</sup>.

There is an interesting skirmish going on in the staid world of company accounting. [Investors](#) and [NGOs](#) are furious. Critical motions in the [UK parliament](#) and the [European parliament](#) have condemned accounting rule makers.

This unprecedented anger is about an accounting rule known as International Financial Reporting Standard 8, or [IFRS 8](#) as it is known in the trade. It is formulated by the [International Accounting Standards Board](#) (IASB) - a private sector [organisation](#) dominated and funded by corporations and big accounting firms. It sets the accounting rules for European quoted companies.

Investors are unhappy because the accounting standard (IFRS 8) does not require companies to publish meaningful information about their geographical activities. They want this information to enable them to make assessments of the risks that they face when investing in global companies operating in places as diverse as the UK, USA, the Cayman Islands, Bangladesh and Nigeria. Increasingly, multinational companies face challenges from governments and campaigners on environmental, human rights and tax avoidance issues. The resulting litigation can last for years and the outcomes and effects on profits can be uncertain, as shown by the experience of [GlaxoSmithKline](#). It took 17 years of litigation and a payment of \$3.1bn to settle a tax dispute with the US government.

Naturally, investors want to know more about corporate practices in each country and risks to their returns. They lobbied the IASB, but major companies don't want to publish that kind of information. The IASB has sided with major corporations. Instead, the standard (IFRS 8) gives company management discretion on whatever they might choose to publish. It does not set any benchmarks for disclosures either.

The National Association of Pension Funds (NAPF), the Investment Management Association (IMA) and the Association of British Insurers (ABI)

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<sup>10</sup> Sikka, P. (2007). Unaccountable, *The Guardian* (Comment is Free), 4 September ([http://commentisfree.guardian.co.uk/prem\\_sikka\\_/2007/09/unaccountable.html](http://commentisfree.guardian.co.uk/prem_sikka_/2007/09/unaccountable.html)).

have described the accounting standard as "[idiotic](#)". The [International Corporate Governance Network](#), representing international and private investors worth about \$10 trillion, has written to the European [Commissioner](#) for the internal market and services to object to IFRS 8 because it removed the need for companies to provide information on "geographical segmentation, which is undoubtedly important for investors".

As accounting rules affect distribution of wages, dividends, taxes, pensions and social welfare generally, NGOs have also begun to take interest in accounting issues. Nearly 80 [NGOs](#) wrote to the IASB to object to the draft leading to IFRS 8. The NGOs, such as [Global Witness](#), support a "[country-by-country](#)" approach. This would require multinational companies to publish a table showing all the countries they operate from, together with turnover, profits, taxes, assets, liabilities and employees in each. It could also cover carbon emissions.

The country-by-country approach would highlight some interesting situations. For example, NewsCorp has lots of economic activities (Sky TV, newspapers) in the UK but pays little corporation tax. [Microsoft](#) has relatively few employees in Ireland, but over \$16bn of assets and \$9bn of profits. How can that be? So the country-by-country approach would highlight anomalies and create possibilities of questions by investors, citizens and the authorities.

Investors and NGOs appear to have found a common ground, but the IASB completely ignored their concerns. The European parliament has now asked the [European Commission](#) to conduct an impact study. Major [companies](#) and accountancy trade associations continue to oppose change.

The above episode shows the folly of allowing private organisations to make public policies. Privately funded regulators cannot bite the hand that feeds them. The public rhetoric is that the IASB creates accounting rules for the benefit of investors, but that is not evident from the case described here. The IASB also claims that its rules benefit society generally, but has totally ignored the concerns of NGOs.

To some observers, accounting debates may appear boring, technical and grey, but accounting practices affect taxes, perceptions of risk and the value of people's savings, investments, pensions and access to education and healthcare. Accountancy rules affect public welfare and they should be made by a democratic organisation that is independent of big business and accounting firms.

It should be noted that the NGOs co-ordinated their efforts through Richard Murphy, who sought meetings with the IASB, but its officials showed no interest in meeting him. The IASB, however, seems to have little difficulty in advancing the agenda of its corporate sponsors.

The EU Commissioner, without taking any evidence from supporters of the 'country-by-country' approach supported the IASB. This matter has subsequently been debated



on European Parliament. On 23 September 2008, the European Parliament noted<sup>11</sup> that it

“Regrets that the Commission does not place more emphasis on the mobilisation of internal resources to finance development, as these are sources of greater autonomy for developing countries; encourages Member States to be fully involved in the extractive industries transparency initiative and to call for it to be strengthened; calls on the Commission to ask the International Accounting Standards Board (IASB) to include among these international accounting standards a country-by-country reporting requirement on the activities of multinational companies in all sectors”

The above provides some evidence to highlight the difficulties in persuading the IASB to look beyond its box.

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<sup>11</sup> <http://www.europarl.europa.eu/sides/getDoc.do?type=REPORT&reference=A6-2008-0310&language=EN&mode=XML#title3>