Parliamentary Commission on Banking Standards

A joint committee of the House of Commons and the House of Lords

Panel on Tax, Audit and Accounting

Written Evidence in response to call for evidence made on 4 December 2012

List of written evidence

	Page
David Cairns	73
Prof Michael Devereux and Dr John Vella	61
Prof Stella Fearnley and Prof Shyam Sunder	1
International Accounting Standards Board (IASB)	17
Prof Prem Sikka	24

Written evidence submitted by Professor Stella Fearnley (Bournemouth University) and Professor Shyam Sunder (Yale School of Management)

We welcome the opportunity to submit evidence to the Parliamentary Commission on Banking Standards Panel on tax, audit and accounting. Much of our evidence draws on our analysis and views of the issues raised by the Panel in our earlier submissions dated 3 September and 31 October, 2012 in response to the call for evidence from the Commission. We refer to these previous submissions where relevant, without repeating them in detail. We do not respond to all the questions and confine our comments to the topics where we can make a contribution. We also make some suggestions on relevant accounting and auditing matters not specifically requested in the call for evidence. All documents cited in the paper are available on request (or on the internet as cited). This submission should be read in conjunction with our submissions of 3 September and 31 October, 2012. The numbered sections in the Summary of Recommendations on pages 2-5 match the numbers in the detailed responses on pages 6-16. For ease of reference we have added to each heading in the summary of recommendations both relevant question number in the Panel's call for submissions and the page reference.

We first emphasise the purpose of UK accounting and auditing and then consider how it has been changing under the now failed IFRS / UK GAAP convergence project. We then present our recommendations to the panel and where relevant we refer to the questions in the call for evidence.

Introduction: the purpose of audited accounts

Audited financial statements of companies are a necessary public good for well-functioning capital markets. The media, the financial and industry press, and the internet in the recent decades, also provide vast and important information to capital markets. However, the large volume of such information is of varied and often of unknown reliability. Audited financial statements and less reliable sources of information together seem to function reasonably well when the quality of auditing and news reporting is within reasonable bounds.

Under the UK law auditors contract with a client company to conduct the audit. They have a contractual duty to the company itself and owe a duty of care to the shareholders who are owners of the company. Setting aside the legal and regulatory requirements, the UK Auditing Practices Board (APB), which is part of the Financial Reporting Council (FRC), sums up the role of financial statements, directors and auditors succinctly in the introduction to Ethical Standard (ES1) [1]

> *The primary purpose of the financial statements of an entity is to provide its owners – the shareholders (or those in an equivalent position) – with information on the state of affairs of the entity and its performance and to assist them in assessing the stewardship exercised by the directors (or those in an equivalent position) over the business that has been entrusted to them.*
>
> *The primary objective of an audit of the financial statements is for the auditor to provide independent assurance to the shareholders that the directors have prepared the financial statements properly. The auditor issues a report that includes an opinion as to whether or not the financial statements give a true and fair view. Thus the auditor assists the shareholders to exercise their stewardship.*

[1] Ethical standard (ES1) 2010, UK Financial Reporting Council.

Summary of recommendations and responses to questions

1. **Shifting the focus of UK audited accounts from the UK law towards the US model by changing underlying conceptual frameworks (Q.10 pages 6-8)**
   a) We recommend that the Panel examine the role of the IASB and its persistent denial that its accounting standards helped precipitate the banking crisis. The key questions are: Who in the standard-setting and regulatory bodies knew that bank accounts were misreporting the true state of affairs? Who knew that banks certified to be going concerns were, in fact, at significant risk of not being going concerns? Who knew that he jumbling together of realised and unrealised gains into profit also put the banks at risk of depleting capital by paying unlawful dividends and bonuses[2] out of gains which were neither realised nor realisable.

   b) We recommend that the Panel questions how and why the accounting model has been fundamentally changed. We believe it is unlikely that non-accountant stakeholders, including politicians, possibly regulators, and even directors of the banks are aware that IFRS accounts in some financial institutions are no longer expected to be prudent and/or reliable. Some stakeholders have been denied information about accounting changes since 2005, which had they been aware of, may well have changed their decisions. Despite IASB's claim to serve the decision usefulness objective, the new accounting model of IASB has not helped improved decision making.

   c) We recommend that as a matter of urgency a reliable definition of distributable profits,appropriate for use by UK companies and banks reporting under the IFRS regime, should be prepared by the FRC with legal backing. It is surprising that this fundamental matter has not already been properly addressed.

2. **Mark-to-market (Q 10, Q12 pages 8-9)**
   a) We recommend that given the seriousness of the problems which have arisen from applying mark to market regime in the banking sector, combined with the growth in financial instruments and the influence of financial economics on the accounting model, a wide ranging review by politicians, regulators, stakeholders and other key parties is needed to establish firm principles as to how financial instruments should be accounted for. This review must recognize that the design of many financial instruments is intended specifically to defeat the purpose of accounting and financial regulation. The IASB and its structures cannot be relied upon to deliver the right outcomes in a timely manner.

   b) We recommend that until accounting standards are changed (which could be a lengthy process, if the past history is any guide) UK regulators should authorise whatever short term changes are needed to the mark to market accounting regime in UK banks, to ensure that assets and profits are not overstated in years ending after 31 December 2012**.**

[2] It is possible that non-accountant directors of banks were also misled.

3. **Incurred loan loss provisioning (Q11 page 10)**

   We recommend that immediate action should be taken to adopt expected loss provisioning and to increase loan loss provisions for bank financial statements for years ending in December 2012, including cases where loans have been rescheduled. The Bank of England has shown that bank assets are overstated (see note 11) and banks need to be recapitalised. The sooner this can be done the better it will be for the banks and for society. We cannot afford to wait for the IASB's glacial processes to make changes nor can we assume that the IASB will make the right changes for the UK financial sector.

4. **The true and fair view, IFRS and the EU Regulation of 2002 (Q10 pages 11-12)**

   We recommend that the Panel investigates the circumstance surrounding the use or non-use of the true and fair criterion after the 2005 switch to IFRS. If, as the FRC claims the applicability of true and fair view has not changed, then it is difficult to understand why it is no longer applied to override IFRS standards when necessary and why the audit report was changed by the provisions in the Companies Act to reinforce it. If the true and fair view was compromised, then why does the FRC continue to insist that it was not?

5. **Did IFRS accounting standards contribute to a box-ticking culture to the exclusion of promoting transparency and a 'true and fair view' of the business? (Q13 page 12)**

   Yes

6. **Do we need a special accounting regime for banks? If so, what should it look like?(Q14 page 12)**

   No

7. **Are there any interim measures (such as mandatory disclosure) which could be introduced in the meantime?(Q 15 page 13)**

   We recommend that if bank accounts do not show a true and fair view and do not reflect the economic substance of the banks such as assets being overstated, the numbers themselves should be adjusted.

8. **What are your views on current proposals for improving disclosure and dialogue (with particular reference to discussion papers issued by FSA/FRC)? (Q16 page13)**

   We recommend that the first priority is to get the numbers right and reduce complexity in accounts before more thought is given to further disclosures. Additional disclosures are not free; they reduce the salience in the eyes of the reader of what is already in the report.

9. **Is there a problem arising from the difficulty of qualifying the accounts of a bank? Should auditors be able to 'grade' accounts – from AAA down? What would be the effect of this?(Q17 pages 13-14)**

   We recommend that the current pass/fail grading system for banks be retained and the threat of a qualified report for a bank under their supervision be used to discipline the bank regulators from slackening their vigilance.

10. **Should the scope of audit be widened so that auditors can better express a broader view of the business? For example should auditors comment specifically on issues such as remuneration policy, valuation models or risk? (Q18 page 14)**

    We recommend that until the current problems surrounding confidence in audit are resolved their role should not be extended beyond regulatory returns.

11. **What would be the effect of using return on assets as a performance measure in banks, as opposed to return on equity? (Q19 page 14)**

    We recommend using both.

12. **Are the amendments to the Financial Services and Markets Act 2000 regarding dialogue between regulator and auditor sufficient, or does further work need to be done in this area? (Q20 pages 14-15)**

    We recommend that regular meetings between auditors and regulators should be mandated.

13. **Should there be enhanced powers to better align auditors' incentives with those of regulators (Q 16.1 page 15)**

    We recommend that auditors and directors should have a duty of care to bank regulators as well as shareholders. Also banks should be required to serve the public interest in return for taxpayer support.

14. **Should auditors of banks be obliged to have a primary responsibility to the regulator rather than the client?(Q16.2 page 15)**

    See 13 above

15. **Should regulatory returns be audited? (Q16.3 page 15)**

    We recommend that banks should be able to ask for regulatory returns to be audited, if they believe circumstances require it .

16. **Do we need a special tax regime for banks? If so, what would this look like and what would be priorities for change? Should tax continue to follow accounting with respect to banks? Should the tax system actively seek to influence banking standards and culture? (Q7 page15).**

    We recommend that government should take immediate steps to use the true and fair override in the banking sector to ensure that bank accounts show a true and fair view which would obviate the necessity for separate taxation and accounting systems for banks.

17. **Are banks exploiting regulatory and information arbitrage between FSA, HMRC and auditors? If so, what is needed to address this? (questions 8 and 9 page 16)**

    We recommend that if there is evidence that regulatory arbitrage is taking place then sharing of information between HMRC, FSA and auditors can only be in the public interest and should be facilitated, without the auditors' client confidentiality requirement applying. Further, regulators should adopt their equivalent of accountants' judgment-based true and fair criterion to minimize room for regulatory arbitrage.**The urgent need for re-organisation of the regulatory regime for financial reporting and auditing (page 16)**

We recommend that the FRC is no longer fit for its charge as it has failed to serve its UK stakeholders. Responsibilities for accounting and auditing which currently are shared between the FSA under the Treasury and the FRC under BIS must be urgently reviewed. The British public has been served poorly by this structure. FRC's continuation is inefficient and unacceptable and major change to the regulation of accounting and auditing in the UK is essential. We suggest that the FRC be disbanded and its responsibilities transferred to a completely separate body headed by the UK Listing Authority (UKLA).

Commentary on the call for evidence

1. ***Shifting the focus of UK audited accounts from the UK law towards the US model by changing underlying conceptual frameworks***

UK company law is clear that the purpose of audited accounts is stewardship and accountability of the directors to shareholders for running the business. The shareholders' authority lies in their power to remove directors from office via an annual general meeting (AGM).

Over time UK accounting standard setters have gradually shifted their emphasis away from the stewardship purpose of accounting towards a decision usefulness purpose, i.e., US-style market-based purpose of financial reporting[3]. Under the federal securities laws in the U.S., stewardship is less important as shareholders cannot readily vote the directors out of office at an AGM and litigation plays a key role in shareholder and creditor protection. Note that the corporate law in the U.S. is a state not a federal subject.

In 2002, three years before the EU changeover to IFRS, the IASB and the US standard setter, the Financial Accounting Standards Board (FASB) agreed to work towards converging their standards. This convergence project increased the influence of US standards (US GAAP) and practices on IFRS. After 10 years spending significant IASB and FASB resources, this convergence project was shelved by the FASB in 2012 with support from the US Securities and Exchange Commission. In the meantime, significant US influence on standards already issued remains.

Driven primarily by US federal securities laws and regulation directed at the functioning of capital markets, the US decision usefulness model focuses on providing information for making investment, trading, and resource allocation decisions by present and future investors[4]. Good governance and stewardship are reduced to a secondary function at best.

The stewardship and decision usefulness approaches overlap partially, and they may not seem different to some, but they are. The decision-making approach, with its focus on shareholder protection, takes a narrow view of serving their interests as the raison d'etre of the reporting entity. The stewardship approach takes a broader perspective to include governance of all participants in the entity, including but limited to the shareholders. The UK financial reporting has been gradually moved by the UK Accounting Standards Board (ASB) towards a decision useful model. Since its introduction in 2005, IFRS have also pursued the same trend.

Traditional principles of UK accounting include recording income and expenditure at the time of transactions, each being measured based on the principles of realization, accrual and prudence, to calculate profit and prepare the balance sheet.[5] Prudence requires that assets and profits are not overstated and liabilities and losses are not understated. Also profit should not be recognised until earned and losses should be booked as soon as they are known. Thus, to enable effective stewardship reporting, this accounting model was based on transactions, realisation and reliability following prudence and the true and fair view.

[3] These differences are explained in depth in Tim Bush's 2005 paper: Divided by common language : Where economics meets the law – US versus non US financial reporting models. ICAEW.

[4] In 2002, 3 years before the changeover to IFRS in the EU the IASB and the US standard setter, the Financial Accounting Standards Board (FASB) agreed to converge their standards. This led to a strong US influence on the IASB standards. After 10 years and the use of significant IASB and FASB resources, this convergence plan was shelved by the FASB in 2012.

[5] The changes in the accounting models are discussed at length in Whittington (2008). Fair value and the IASB / FASB conceptual framework project: An alternative view. Abacus. Vol.44. no.2. 2008. Pp. 139-168. Professor Whittington is a former member of the IASB.

Critics of the IASB and the global standards point to the impossibility of reaching agreement on an accounting model across cultures, economic and legal environments, and contexts, especially as the so-called "global" standards were essentially based on what was widely seen to be appropriate for the U.S. and parts of European legal, regulatory and cultural contexts. Whereas some common ground in accounting can be of advantage, particularly for comparability purposes, a monopoly in standard setting brings high risk of implementing defective standards in absence of learning from variety and experimentation in different domains[6]. This we have already discovered when the poor choice of US GAAP influenced IFRS standards contributed to the global financial crisis. The rigidity of the accounting standards ignores the varying reporting needs and contextual issues in different companies as well as different countries[7], and is costly.

Before the IASB / US GAAP convergence project collapsed in 2012, IASB ploughed ahead with determination to move towards a market focused accounting model, and to this end, changed its own conceptual framework in 2010. Reliability and prudence, already ignored by it, were formally discarded from this "new improved" framework in favor of relevance, representational faithfulness, verifiability and neutrality[8]. The chair of the IASB acknowledged that prudence had been taken out because it did not feature in the US framework[9], indicating IASB's subservience to the FASB. The defects of this model are obvious. The assumption that data which is verifiable, neutral and faithfully represents the items being measured assumes that, in spite of voluminous evidence to the contrary, the efficient market hypothesis can be relied upon to be valid literally in its most extreme form.

Prudence and reliability, along with the true-and-fair view and substance over form, had been the cornerstones of UK financial reporting for a very long time. They do not fit with a decision useful regime which applies mark-to-market accounting. The IASB found it convenient to delete prudence and reliability from their conceptual framework as mere nuisances. A major concern is the consequences of this change for the reliability of accounting due to the shift away from a transactions-and-cash related accounting model. This shift renders financial reporting far more vulnerable to manipulation of financial reports to financial engineering[10] in the financial sector.

Representatives of the IASB have continued to deny that the IFRS accounting model played a role in the financial crisis, even as they acknowledge the need for, and execute changes in their standards in response to demands from regulators after the global financial crisis. One unfortunate result of the lack of transparency about the dysfunctional outcomes of the IASB's standards in the financial sector is that non-accountant stakeholders were denied the knowledge that the accounting numbers on which they had relied for so long had been rendered unreliable through a change in the accounting model. They had also opened the door for financial engineering to manipulate the statements.

---

6 See Sunder, S. IFRS monopoly: the Pied Piper of financial reporting. . Accounting and Business Research. 41.3 August 2011. 291-306.

7 See note 4. And

8 IASB (2010), Conceptual Framework for Financial Reporting. IASB, chapter 3. London.

9 The Concept of Prudence: dead or alive? FEE Conference on Corporate Reporting of the Future, Brussels, Belgium, Tuesday 18 September 2012. Hans Hoogervorst, Chairman of the IASB

10 For example, Power, M. "Fair value accounting, financial economics and the transformation of reliability." Accounting and Business Research, Vol. 40. No. 3 2010 International Accounting Policy Forum, pp. 197-210 refers to links between fair value accounting, the growth of derivatives, the revised conceptual frameworks, which change the balance sheet from a legal to an economic institution thus justifying the widespread use of fair values which undermined the traditional view of the balance sheet being reliable. Also, see Sunder, Shyam. "Paradox of Writing Clear Rules: Interplay of Financial Reporting and Engineering." The Japanese Accounting Review. 1 (2011) pp. 119-130 (available at http://www.rieb.kobe-u.ac.jp/tjar/article/vol1/pdf/7.Sunder.pdf).

It is seven years since the IASB standards were introduced in the UK, and despite many promises, little has changed yet to improve the risks inherent in the standards. Representatives of the IASB are now prepared to admit the need for changes in their standards but not yet take responsibility for the widespread damage they inflicted[11]. This behavior is unacceptable for a body that holds itself out to be fit to set accounting standards for the world; given the past record, the IASB and the structures surrounding it can hardly be trusted to do the right thing.

We recommend that the Panel examine the role of the IASB and its persistent denial that its accounting standards helped precipitate the banking crisis. The key question is: who in the standard-setting and regulatory bodies knew that bank accounts were misreporting the true state of affairs; and that banks certified to be going concerns were, in fact, at significant risk of not being going concerns. The jumbling together of realised and unrealised gains into profit also put the banks at risk of depleting capital by paying unlawful dividends and bonuses[12] out of gains which were neither realised nor realisable.

We recommend that the \panelshould raise awareness of how the accounting model has been fundamentally changed. We believe it is unlikely that non-accountant stakeholders, including politicians and possibly regulators and even directors of the banks are aware that IFRS accounts in some financial institutions are no longer expected to be prudent and/or reliable. Some stakeholders have been denied information since 2005, which may well have changed their decisions despite IASB's claim to serve the decision usefulness objective.

We recommend that as a matter of urgency, a reliable definition of distributable profits appropriate for use by UK companies and banks reporting under the IFRS regime should be prepared by the FRC with legal backing. It is surprising that this fundamental matter has not been properly addressed already.

2. *Mark-to-market*

Some trading assets in financial institutions were marked to market prior to 2005 under a statement of recommend practice (SORP) issued by the British Bankers Association[13] and endorsed as a recommendation by the UK Accounting Standards Board. However, IFRS brought in a much wider ranging mark-to-market regime for securities and financial instruments than had previously been applied. This SORP was subject to the constraints of the UK's own accounting regime which required prudence and the true-and-fair view to apply to assets which were marked to market.

Under the UK SORP regime, assets could be marked to market provided that dealing positions were of normal liquidity, i.e., near cash. The IFRS standard IAS 39 by not restricting mark-to-market to liquid dealing positions, opened the door to recognition as profits of real or imagined gains on assets marked to thinly traded markets or marked to models.

A key point about marking assets to thin or illiquid markets, or markets in a bubble, is that these prices may have little relationship with the value of the asset. If a market is deep and liquid, assets find their price through frequent trading. In a thin or mark to model market or a bubble regime

[11] For example a statement made by IASB on 14 December 2012 reads: IAS 39 *Financial Instruments: Recognition and Measurement* has many classification and measurement categories that are not based on clear or consistent rationales. It also has different impairment models that apply to financial assets depending on how those assets are classified. Moreover, IAS 39 requires bifurcation of complex instruments using a set of rules that are often unclear and inconsistent. http://www.ifrs.org/Investor-resources/2012-perspectives/December-perspectives/Pages/Patrick-Finnegan-IFRS-9-December-2012.aspx.

[12] It is possible that non-accountant directors of banks were also misled.

[13] http://www.bba.org.uk/media/article/bba-statements-of-recommended-accounting-practice-sorps.

where a reliable market price cannot be identified, it is possible for traders to recognise false and non-existent profits. For example, "*bed and breakfast"* transactions between different organisations may involve a sale and buy back to realise a profit, and set a price which is then used for many other assets of the same type without trading them; or simply by swapping assets between different institutions to set a price. If the assets had to be sold in an open market in order to realise a profit the price would be different.

The IFRS incurred loan loss model requires provisions to be made only when there is already evidence of default, and does not recognise long term credit risk in all loan portfolios. The Local Authority Pensions Fund Forum[14] paper demonstrates how the incurred loss model resulted in bank assets being significantly overstated. Asset overstatement is also referred to at length in the The dangers of derivatives and mark to market were articulated clearly by Warren Buffet in the 2002 annual report of Berkshire Hathaway[15], well before the financial crisis. He wrote: *I can assure you that the marking errors in the derivative business have not been symmetrical. They have favoured either the trader who was eyeing a multimillion dollar bonus or the CEO who wanted to report impressive earnings … These instruments will almost certainly multiply in variety and number until some event makes their toxicity clear. Central banks and governments have so far found no effective way to control, or even monitor, the risks posed by these contracts'.*

The significant growth in proprietary trading and in origination of sub-prime mortgage based financial instruments has created an environment where a greater proportion of bank assets were marked to market or to model. In the rising market significant unrealised gains emerged which were treated as profits available for bonuses and dividend distributions. Concerns about financial instruments, mark to market accounting and the accounting treatment of unrealised gains have also been expressed by regulators[16].

Banks trading in securities use mark to market all the time to report on and facilitate their trading activities. However mark to market is not the appropriate model to use in valuing assets for the purpose of drawing up a point-in-time balance sheet on which a varied set of stakeholder groups, many poorly informed, rely.

We recommend that given the seriousness of the problems which have arisen from the mark to market regime in the banking sector, combined with the growth in financial instruments and the influence of financial economics on the accounting model, a wide ranging review by politicians, regulators, stakeholders and other key parties is needed to establish firm principles as to how financial instruments should be accounted for. This review must recognize that the design of many financial instruments is intended specifically to defeat the purpose of accounting and financial regulation. The IASB and its structures cannot be relied upon to deliver the right outcomes in a timely manner.

We recommend that until accounting standards are changed (which could be a lengthy process, if the past history is any guide) UK regulators should authorise whatever short term changes are needed to the mark to market accounting regime in UK banks, to ensure that assets and profits are not overstated in years ending after 31 December 2012.

---

[14] Local Authority Pension fund Forum (2011) UK and Irish Banks Capital Losses – Post Mortem. LAPF Forum. London.

[15] http://www.berkshirehathaway.com/2002ar/2002ar.pdf pp 14-16.

[16] Lord Turner of Ecchinswell described financial instruments as *socially usel*ess. Daily Telegraph 26 August 2009 http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/6096546/City-is-too-big-and-socially-useless-says-Lord-Turner.html. Andrew Haldane explains the defects of the mark to market regime in a speech , 19 December 2011: http://bankofengland.co.uk/publications/speeches.

3. ***Incurred loan loss provisioning (q11)***

November 2012 Bank of England Financial Stability Report issue 32[17]. This report also makes reference to mark to market accounting as problem.

Overstatement of bank assets resulted in (1) solvency and liquidity ratios being distorted allowing banks to continue lending when they should have stopped; (2) undermining the claim of these banks to be going concerns because their overstated assets were not convertible into cash; and (3) failing to protect bank capital as the overstated profits (resulting from insufficient loan loss provisioning) were available and often used to pay bonuses and dividends. This last factor exposed the directors of the banks to potential penalties for unlawful distributions and other payments which could lead to the insolvency of the bank.

A particular problem arises with loan forbearance. If a defaulting borrower is able to renegotiate the payment timetable with the lender, adhering to the new schedule does not mean that the loan Is not impaired. Yet, under IFRS standards, such defaults can remain hidden from the view of the readers of financial reports.

We recommend that immediate action should be taken to adopt expected loss provisioning and to increase loan loss provisions for bank financial statements for years ending in December 2012, including cases where loans have been rescheduled. The Bank of England has shown that bank assets are overstated (see note 11) and banks need to be recapitalised. The sooner this can be done the better it will be for the banks and for society. We cannot afford to wait for the IASB's glacial processes to make changes nor can we assume that the IASB will make the right changes for the UK financial sector.

4. ***The true and fair view, IFRS and the EU Regulation of 2002 (q10)***

The true and fair view and the principles of reliability and prudence were part of UK accounting before the introduction of IFRS. As with the change of emphasis in the accounting model described above, non-accountants may not have known of concerns about the impact of the EU regulation on the true and fair view. Nevertheless users would expect the true and fair view to contribute to the reliability of audited numbers.

Article 3 of the 2002 EU Regulation which mandated IFRS (referred to as IAS in the Regulation) in the EU for group accounts of listed companies states that IAS can only be adopted if they are not contrary to article 2 (3) of Directive 78/660 and article 16(3) of Directive 83.349[18] and are conducive to the European public good. The two directives require company and group accounts to show a true and fair view and allow member states to set the rules for using true and fair[19]. The regulation

[17] See http://www.bankofengland.co.uk/publications/Pages/fsr/2012/fsr32.aspx.

[18] 'This directive applies the same principles to group accounts.

[19] Articles 2(3-5) of directive 78/660/EEC state that: The annual accounts shall give a true and fair view of the company's assets, liabilities, financial position and profit or loss. Where the application of the provisions of this Directive would not be sufficient to give a true and fair view within the meaning of paragraph 3, additional information must be given. Where in exceptional cases the application of a provision of this Directive is incompatible with the obligation laid down in paragraph 3, that provision must be departed from in order to give a true and fair view within the meaning of paragraph 3. Any such departure must be disclosed in the notes on the accounts together with an explanation of the reasons for it and a statement of its effect on the assets, liabilities, financial position and profit or loss. The Member States may define the exceptional cases in question and lay down the relevant special rules.

requires IFRS to meet the criteria of understandability, relevance, reliability, and comparability. In fact, reliability and understandability have not been met. Now that IASB is no longer locked into its convergence project with US GAAP, it is an appropriate time for the EC to review the IASB standard setting process, the approval process and to resolve the problems with IASB standards and procedures.

Questions were raised in the UK by some investors in 2005 as to whether IFRS had undermined the true and fair view. One of its standards (IAS1) indicated that accounts prepared under IFRS were de facto true and fair and only in very rare circumstances would deviation from the standards be expected. As a result the FRC issued a statement in 2005[20] confirming that (1) the concept of true and fair view remains a cornerstone of financial reporting and auditing in the UK ; (2) there has been no substantive change in the objectives of an audit and the nature of auditors' responsibilities; and (3) the need for professional judgment remains central to the work of preparers of accounts and auditors in the UK. In its latest submission to the Commission, FRC continues to insist that "…this concept is not something that should be seen as a separate add-on to accounting standards but as their essence." This position significantly dilutes the force of true-and-fair override when the application of written standards do not yield results which are true and fair in common sense meaning of the phrase.

After further concerns were expressed, Counsel's opinion was obtained by the FRC in 2008 which reinforced the FRC's 2005 position and further guidance on true and fair was issued in 2011. Although the FRC insisted that true and fair had not been compromised, amendments were made to the 2006 Companies Act to ensure that the true and fair view is not dependent on compliance with IFRS but is a stand alone requirement.

The wording of the UK audit report therefore changed three times between 2004 and 2010 regarding the true and fair view. The 2004 report refers to the financial statements showing a true and fair view. The 2005 post IFRS audit report refers to the financial statements showing a true and fair view in accordance with IFRS . The wording after the 2006 Companies Act amendment which took effect in 2009/10 2010 refers to the financial statements giving a true and fair view and compliance with IFRS is a separate point. Interestingly the financial crisis developed when the audit report did not appear to required the true and fair view to be a separate point from IFRS.

Research by Beattie and Fearnley[21] (2001) into auditor / company relations shows that before IFRS was introduced in the UK, auditors of listed companies used the true and fair view as a negotiating tool in cases where directors wanted to engage in creative accounting or account inappropriately for a complex transaction. Use of true and fair criterion is visible to public only when it is used to override literal interpretations of law and regulations in favor of common sense. The threat from an auditor to qualify an audit report on the grounds of the financial reports failing to provide a true and fair view was used as a deterrent to directors wanting to misreport numbers along with the threat of a Financial Reporting Review Panel investigation.

Beattie et al.'s second project into auditor company relations following the UKs post-Enron regulatory changes and the introduction of IFRS and ISAs in 2005, found that true and fair is now used only in negotiations regarding unusual transactions which are not covered in IFRS. The force of the true and fair has been dissipated by the new practice of it being interpreted as little more than compliance with the IFRS standards. Auditors in the field now tend to rely to a much greater degree on the audit firms' technical departments, instead of the judgment in the field. Some preparers and

---

[20] FRC (2005) Press notice 119. FRC London.
[21] Beattie,V. Fearnley, S and Brandt, R. 2001. Behind closed doors, What company audit is really about. Palgrave.

auditors were uncomfortable with the results of applying IFRS. One audit partner described IFRS as producing 'magical results'. One CFO said 'you actually end up with numbers that no-one really signs up to'. An audit committee chair said: 'the rules actually allowed for a contrived structure which in some circumstances will collapse'. Beattie et al. (2008)[22] found that preparers and auditors believed that IFRS had undermined UK accounting integrity. However although some preparers were not always convinced their accounts showed a true and fair, Beattie et al. found no efforts among preparers to change that situation. They accepted that this is now how it is.

We recommend that the Panelinvestigate the situation surrounding the use or non-use of the true and fair criterion after the 2005 switch to IFRS. If, as the FRC claims the applicability of true and fair view has not changed, then it is difficult to understand why it is no longer applied to override IFRS standards when necessary and why the audit report was changed by the provisions in the Companies Act to reinforce it. If the true and fair view was compromised, then why did the FRC insist that it was not?

5. ***Did IFRS accounting standards contribute to a box-ticking culture to the exclusion of promoting transparency and a 'true and fair view' of the business? (q13)***

Research by Beattie, Fearnley and Hines in 2007/8[23] indicates that finance directors, audit committee chairs and auditors of UK listed companies felt that the change in the regime both for accounting, auditing and enforcement had led to a compliance-driven box-ticking environment. This had changed significantly from the previous regime and had been driven by: (1) a more rigorous post-Enron enforcement regime including the introduction of audit inspection and the more pro-active role taken by the Financial Reporting Review Panel; (2) the introduction of International Standards of Auditing (ISAs) by the UK Auditing Standards Board with more detailed set of requirements; and (3) IFRS. The researchers concluded that in a strong enforcement regime such as in the UK, the quality of the accounting and auditing standards being enforced is paramount; any defects in the standards flow directly to the final accounts.

So the answer to this question based on Beattie et al.'s research is an emphatic 'yes'.

6. ***Do we need a special accounting regime for banks? If so, what should it look like?***

It is essential that accounting numbers for banks comply with the same rules as for any other companies in the UK. Otherwise users will not know what to believe. Prudential regulators already receive additional information from banks, and they have the authority to demand more and different information. If prudential regulators were to require the basic accounting principles for banking to be different, inclusion of such "special accounting" numbers in the published financial statements will only mislead the other stakeholders, including shareholders. As referred to above we should make whatever changes are needed to the regime for UK financial reporting to ensure that all published accounts show a true and fair review and reflect substance over form. Prudential regulators should remain free to demand additional or different information from the banks without inclusion of such information in the published financial reports provided that the underlying numbers are consistent with the audited accounts.

The answer to this question is no.

---

[22] Beattie, Fearnley and Hines (2008) Does IFRS undermine UK accounting integrity. Accountancy magazine, December, 56-57.

[23] Beattie , V. Fearnley,S and Hines, T. (2011) Reaching key financial reporting decisions: How directors and auditors interact. Wiley. London.

7. ***Are there any interim measures (such as mandatory disclosure) which could be introduced in the meantime?***

Interim measures should go beyond additional disclosure. It is the numbers that need to be changed.

We recommend that if bank accounts do not show a true and fair view and do not reflect the economic substance of the banks such as assets being overstated, the numbers themselves should be adjusted.

8. ***What are your views on current proposals for improving disclosure and dialogue (with particular reference to discussion papers issued by FSA/FRC)?***

Bank auditing and accounting should present accounts that (1)show a true and fair view and reflect the economic substance of the business; (2) be reliable and prudent ; (3) be fit for the purpose of distributing dividends and bonuses; (4) show that the bank is a going concern and (5) be believable.. If these properties are attained in bank accounts, the case for further disclosure and adding more to the lengthy financial statements already produced by them under IFRS is not strong. If there is a belief that more information is required then some other information should be taken out. Every paragraph added to reports reduces the attention received by what is already in the report.

We recommend that the first priority is to get the numbers right and reduce complexity in accounts before more thought is given to further disclosures. Additional disclosures are not free; they reduce the salience in the eyes of the reader of what is already in the report.

9. ***Is there a problem arising from the difficulty of qualifying the accounts of a bank? Should auditors be able to 'grade' accounts – from AAA down? What would be the effect of this?***

This issue amounts to asking whether the essential pass/fail grading system of auditing should be made finer by adding more grades. In their study of grading systems, Jamal and Sunder[24] (2011a and b) report that the optimal grading system depends on the accuracy of the grading process. When the grading process is more error prone, it is better to keep the grading scheme coarse (i.e., fewer grades). Given how error prone the auditing system is, it is difficult to see if it can support a finer system of grading than what we currently have.

As banking business is based on confidence, loss of confidence in one bank can undermine confidence in the others, particularly if they have been engaging similar activities. Thus a qualified audit report in a significant institution would be a problem for regulators in controlling the stability of the sector, unless the qualification could be identified and explained by the bank and the regulator as specific to events in one institution.

We agree that a qualified audit report in a bank could be destabilising for the sector and would have to be carefully managed by the regulator so no bank gets even close to the situation where

[24] Jamal, Karim and Shyam Sunder. "Is mandated independence necessary for audit quality?" *Accounting, Organizations and Society* 36 (2011a), pp. 284-292 (http://faculty.som.yale.edu/shyamsunder/Research/Accounting%20and%20Control/Published%20Articles/175.Is_Mandated_Independence/PublishedBaseballCardsAOSOct2011.pdf) ; and Jamal, Karim and Shyam Sunder. "Unregulated Markets for Audit Services." *The Japanese Accounting Review*, 1 (2011b), 1-16 (http://faculty.som.yale.edu/shyamsunder/Research/Accounting%20and%20Control/Published%20Articles/181.Unregulated_Markets_JAR_2011/Unregulated_Markets_for_Audit_Services_2011.pdf)..

it might get a qualified report. That is the purpose of the report and of an effective system of bank regulation. Qualified report amounts to failure of the regulatory mechanism, in which case it would be dysfunctional to worry about a qualified report destabilizing the system. Why stabilize a broken system which is crying out to be fixed?

We recommend that the current pass/fail grading system for banks be retained and the threat of a qualified report for a bank under their supervision be used to discipline the bank regulators from slackening their vigilance.

10. ***Should the scope of audit be widened so that auditors can better express a broader view of the business? For example should auditors comment specifically on issues such as remuneration policy, valuation models or risk?***

We do not believe that it is appropriate for auditors to take on more responsibility until the existing issues about accounting and auditing have been satisfactorily resolved, particularly matters raised in the FSA/FRC joint paper 10/3[25] and concerns raised by the Bank of England about over-valuation of assets in their November 2012 Financial Stability Report. Auditors have enough on their plate, and they have had obvious difficulties in handling their current responsibilities. Adding additional responsibilities for them is not a responsible course of action at this time.

We have suggested in our earlier submissions that excessive pay should be a matter for a government commission as it has become such a major public concern. Prudential bank regulators may be able to handle this better than the auditors.

We recommend that until the current problems surrounding confidence in audit are resolved their role should not be extended beyond regulatory returns.

11. ***What would be the effect of using return on assets as a performance measure in banks, as opposed to return on equity?***

For complex businesses like banks, no single measure of performance is sufficient. There is little reason for not using both.

We recommend using both

12. ***Are the amendments to the Financial Services and Markets Act 2000 regarding dialogue between regulator and auditor sufficient, or does further work need to be done in this area?***

Regular face-to-face meetings should be required between auditors and regulators even if the agenda is short as it gives an opportunity for exchange of views about specific banks, beyond discussions for reporting of problems and the annual accounts.

Joint meetings could be held with auditors and audit committees but there should be at least one meeting per year where the regulator talks to the audit committee without the auditor present. A view of the auditor from the company is just as important as a view of the company from the auditor.

---

[25] Financial Services Authority and Financial Reporting Council (2010) Enhancing the auditors' contribution to prudential regulation. Discussion paper 10/3. June.

Had these meetings taken place after the IFRS changeover, regulators might have been made more aware of the impact of deficiencies in the accounting model and problems being faced by auditors in agreeing the valuations of financial instruments and loan loss provisions.

We recommend that regular meetings between auditors and regulators should be mandated.

13. ***Should there be enhanced powers to better align auditors' incentives with those of regulators***

Under UK law, the auditor's primary duty is to the shareholders. The unique role of banks in society, supports a a case for the auditor to have a duty of care towards the regulator as well. If this is done then the directors of the company must also have a duty of care to the regulator and both auditor and directors should be required to act in the public interest.

We recommend that auditors and directors should have a duty of care to bank regulators as well as shareholders. Also banks should be required to serve the public interest in return for taxpayer support.

14. ***Should auditors of banks be obliged to have a primary responsibility to the regulator rather than the client?***

See above

15. ***Should regulatory returns be audited?***

We suggest that banks should be responsible for providing their regulators with a statement of reconciliation if needed between their published statements and regulatory returns. The regulators have enough power and resources to do the rest. Banks should be able to ask for regulatory returns to be audited if they wish.

We recommend that banks should be able to ask for regulatory returns to be audited, if they believe circumstances require it.

16. ***Do we need a special tax regime for banks? If so, what would this look like and what would be priorities for change? Should tax continue to follow accounting with respect to banks? Should the tax system actively seek to influence banking standards and culture? (question 7).***

Setting up separate taxation regimes for banks would be unnecessarily complicated and will give rise to new tax arbitrage and avoidance strategies. If the accounts of banks are trustworthy and show a true and fair view then there should be no reason why taxation should not continue to follow accounting. The UK government should recognise the dysfunctional outcomes that the IFRS mark to market and incurred loan loss accounting model has caused in the banking sector and put this right as a matter of urgency by means of the true and fair override. The UK should not wait for the outcomes of the IASB's multi layered and lengthy processes to bring about 'improvements' but take immediate action to deal with the problem with accounting numbers in banks in the UK's public interest.

We recommend that government should take immediate steps to use the true and fair override in the banking sector to ensure that bank accounts show a true and fair view which would obviate the necessity for separate taxation and accounting systems for banks.

17. ***Are banks exploiting regulatory and information arbitrage between FSA, HMRC and auditors? If so, what is needed to address this? (questions 8 and 9)***

We are not in a position to comment on whether banks are exploiting regulatory and information arbitrage between FSA, HMRC and auditors. We can see no reason why all relevant information should not be shared between the bodies named. In situations such as this client confidentiality for auditors should not apply.

Many if not most regulatory arbitrage opportunities arise when regulators try to make the rules "perfectly clear" by writing down all the details leaving little room for discretion. Without a regulatory equivalent of accountants' "true and fair" criterion, regulatory arbitrage is inevitable. Only allowing for regulator judgment in the regulatory framework can help deal with this problem.

However, the system to date has been confusing, particularly in respect of accounting and auditing as responsibility for accounting and auditing is shared between FRC and FSA thus involving two government departments: the Treasury and the Department of Business, Innovation and Skills (BIS). This should be rationalised with clear lines of responsibility.

We recommend that if there is evidence that regulatory arbitrage is taking place then sharing of information between HMRC, FSA and auditors can only be in the public interest and should be facilitated, without the auditors' client confidentiality requirement applying. Further, regulators should adopt their equivalent of accountants' judgment-based true and fair criterion to minimize room for regulatory arbitrage.

18. ***The urgent need for re-organisation of the regulatory regime for financial reporting and auditing***

A day before we finalised this submission, an additional submission by the Financial Reporting Council was placed on the Banking Commission's website. We note that the FRC's position on IFRS problems has shifted towards the views we express in this submission and in our previous submissions of 3 September and 31 October 2012.

The Panel may wish to inquire why the FRC has chosen to change its position from the stance it maintained until recently and why it has taken so long to acknowledge that there is a serious problem for UK accounting with the IFRS accounting model and its conceptual framework.

We recommend that the FRC is no longer fit for its charge as it has failed to serve and protect its UK stakeholders. Responsibilities for accounting and auditing which currently are shared between the FSA under the Treasury and the FRC under BIS must be urgently reviewed. The British public has been served poorly by this structure. FRC's continuation is inefficient and unacceptable and major change to the regulation of accounting and auditing in the UK is essential. We suggest that the FRC be disbanded and its responsibilities transferred to a completely separate body headed by the UK Listing Authority (UKLA).

21 December 2012

Written evidence submitted by the International Accounting Standards Board

1. This memorandum sets out the response of the International Accounting Standards Board (IASB) to a number of questions set out in the call for evidence issued on 4 December 2012 by the Parliamentary Commission on Banking Standards' Panel on tax, audit and accounting.

About the IASB

2. Established in 2001, the IASB is the standard-setting body of the International Financial Reporting Standards (IFRS) Foundation, an independent private sector, not-for-profit organisation. The IASB is committed to develop, in the public interest, a single set of high-quality, understandable, enforceable and globally accepted financial reporting standards based upon clearly articulated principles. Those standards should serve investors and other market participants in making informed resource allocation and other economic decisions. The confidence of all users of financial statements is critically important for the effective functioning of capital markets, efficient capital allocation, global financial stability and sound economic growth.

3. In pursuit of this objective, the IASB develops its standards by conducting an extensive due process, which is founded on the principles of transparency, full and fair consultation and accountability.

4. IFRSs, as established by the IASB, are now used in more than 100 countries, including three quarters of the G20 and all the Member States of the European Union.

Global accounting standards

5. The G20 have made repeated calls for the achievement of a single set of high quality global accounting standards and they, together with the Financial Stability Board (FSB) have reinforced the importance of this as one of the financial regulatory reforms in response to the crisis. Academic research commissioned by the IFRS Foundation on the benefits and consequences of global accounting standards[1] demonstrates the benefits that can result from the adoption of IFRSs, in particular when IFRS application is supported by a framework that encompasses legal protections, competent professionals and adequate monitoring and enforcement.

Q10 – What was the role of accounting standards and reliance on fair value principles in the banking crisis? What does a 'true and fair view' really represent to the market?

6. Accounting standards played a very limited part in the onset of the banking crisis. Although some assert that current accounting standards allowed banks to paint too rosy a picture of their true financial condition, there is very little evidence to support this assertion. Indeed, the financial statements of the banks prior to the crisis clearly showed that most banks were extremely leveraged and in a very perilous condition[2]. The balance sheets of many banks were supported by 2% of

---

[1] Tarca (2012) 'The Case for Global Accounting Standards: Arguments and Evidence', available at: http://www.ifrs.org/Use-around-the-world/Documents/Case-for-Global-Accounting-Standards-Arguments-and-Evidence.pdf.

[2] See, for example, the FSA Board Report (December 2011) 'The failure of the Royal Bank of Scotland', Graph 2.1, Leverage for Selected Firms, taken from published annual accounts (page 67) http://www.fsa.gov.uk/library/other_publications/miscellaneous/2011/rbs.shtml.

tangible capital or even less, a degree of leverage which was unprecedented in economic history and clearly visible in financial statements. In retrospect, it is remarkable that market participants failed to pick up the very clear signals of excessive leverage in financial statements. One of the reasons why this did not happen was that many market participants were focussed on the so-called Basel capital ratios[3]. This regulatory measurement method allowed the banks to calculate their capital ratios on the basis of risk weighted assets. It is well documented how, before the crisis, the Basel capital ratios had been gamed to increase leverage by exploitation of the risk weights. Banks with a seemingly sound Tier-1 ratio of 10 per cent could in fact be leveraged 40 or 50 times. The Basel ratios had been abused as a scheme for hiding the excessive and very dangerous leverage which market participants could and should have observed in the financial statements of the banking industry.

7. As for reliance on fair value principles, it is not the case, as some have claimed, that the IASB is seeking a full fair value model for financial instruments. Both the existing standard IAS 39 *Financial Instruments: Recognition and Measurement* and as well as its replacement IFRS 9 *Financial Instruments* provide for a mixed attribute model. While fair value is an appropriate measurement attribute for financial instruments that are traded, in IFRS 9 financial instruments that have basic loan features and that are managed on a contractual yield basis are measured at amortised cost. For such instruments, amortised cost is deemed to provide more relevant information. It is the case that the majority of banks' financial assets are still valued on an amortised cost basis rather than fair value[4] and that many of the assets that have been written-down have been those held at amortised cost. For this reason, most academic evidence available shows that the claim that fair value accounting exacerbated the financial crisis appears to be largely unfounded[5].

9. In part, fair value accounting actually helped to reveal the crisis, in particular through requiring the banks to report losses earlier than under any other accounting basis, as was demonstrated by the recent write-downs of Greek sovereign debt. This had the benefit of focusing attention much earlier on the banks' business models and led to remedial action, such as capital raising, much sooner than otherwise would have been the case.

10. In sum, we do not support the notion that accounting standards led to a systemic bias to overly favourable financial statements in the banking industry. Clear signals that the banking industry was extremely leveraged were simply not picked up. However, we do acknowledge that the incurred loss model for the impairment of assets was in need of improvement. Indeed, the IASB is currently in the process of replacing the incurred loss model by an expected loss model. Our proposals to improve our standards in this respect are outlined in the answer to Question 11 below.

---

[3] Formally the 'Revised Framework on International Convergence of Capital Measurement and Capital Standards' (Basel II) issued in June 2004 by Basel Committee on Banking Supervision.

[4] As reported in, for example, the final report of the Financial Crisis Advisory Group (July 2009), page 4 http://www.ifrs.org/News/Press-Releases/Documents/FCAGReportJuly2009.pdf

[5] See, for example, Laux and Leuz (2010) 'Did Fair-Value Accounting Contribute to the Financial Crisis?' (Journal of Economic Perspectives, Volume 24, Number 1, Winter 2010, pages 93-118) http://nd.edu/~carecob/April2011Conference/LeuzPaper.pdf

A true and fair view to the market?

12. The IASB develops standards that provide a faithful portrayal of an entity's financial position and performance in its financial statements. The application of IFRSs, with additional disclosures when necessary, is presumed to result in financial statements that achieve a fair presentation, which in our view represents a true and fair view to the market.

13. The UK Financial Reporting Council (FRC) sought Counsel's Opinion in 2008 on the issue of true and fair. The Opinion by Martin Moore QC[6] concluded that "the requirement set out in applicable accounting standards to present fairly is not a different requirement to that of showing a true and fair view, but is a different articulation of the same concept". Mr Moore's Opinion was made before changes were made to the IASB's Conceptual Framework in 2010 in which the qualitative characteristic of prudence was replaced by neutrality. Some take the view that this had rendered Mr Moore's Opinion out of date. However, we note that the importance of true and fair was reaffirmed by the FRC in a follow up paper in 2011[7] and – in that paper – the FRC, noting the change in the Framework, commented that: "However, in practice the concept of prudence continues to underlie the preparation of accounts under both UK GAAP and IFRS". We also note the view of the UK Government that IFRS has not led to a loss of prudence[8]. A recent speech by Hans Hoogervorst[9] maintained that, despite its removal from the Framework, the basic tenets of the concept of prudence remain intact and visible throughout IFRSs, for example in the IASB's proposals for leasing, under which entities will recognise on their balance sheets assets and liabilities arising from leases.

14. For IFRSs to be adopted legally for use in the European Union, each standard and Interpretation has to be endorsed by the European Commission. The endorsement criteria[10] include a requirement that each of them is 'not contrary' to the principle of providing a true and fair view as set out in the EU Accounting Directives. All the standards endorsed for use in the EU have met that criterion.

Q11 What are your views on the current incurred-loss impairment model and its role in the banking crisis? Do you consider that proposals to move to an expected-loss model will address criticisms of the current accounting rules?

15. A well-functioning impairment model is of paramount importance for an amortised cost measurement to be reliable and credible. The IASB acknowledges that the current incurred-loss impairment model was criticised after the outbreak of the crisis for being too little, too late.

---

6 Available at: http://www.frc.org.uk/FRC-Documents/FRC/True-and-Fair-Opinion,-Moore,-21-April-2008.aspx

7 FRC (June 2011) 'True and Fair' http://www.frc.org.uk/FRC-Documents/FRC/Paper-True-and-Fair.aspx

8 Response of the UK Government to the House of Lords Economic Affairs Committee report 'Auditors: Market Concentration and their Role' (19 May 2011) http://www.publications.parliament.uk/pa/ld201012/ldselect/ldeconaf/157/15704.htm.

9 'The Concept of Prudence: dead or alive?' (18 September 2012) http://www.ifrs.org/Alerts/Conference/Pages/prudence-speech-Sept-2012.aspx

10 As set out in Regulation 1606/2002 of 19 July 2002 on the application of international accounting standards, Official Journal L243, 11 September 2002, pages 1-7.

16. We think that this criticism was partially justified[11]. There are a number of factors as to why the market capitalisation of many banks is far below their book value, only one of which relates to the view of market participants about the current level of provisions. One also needs to consider the risk premium now demanded by the market and which is factored into fair value but which, even with expected loss, would be absent from amortised cost. Also, another factor positively impacting book values is the continued recognition of intangibles, including goodwill, in bank balance sheets.

17. In the IASB's view, the incurred loss model could have been applied much more vigorously in the last couple of years, such as in the example of the late write-downs by banks of their holdings of Greek government bonds. Under the relevant standard IAS 39*,* an impairment is recognised if there is objective evidence that the loan has been impaired since the date it was originated. Some have read this as implying that a default has to occur for an allowance to be made. In fact the approach is to book allowances when there is "objective evidence" of impairment, which could for example be that the borrower is in "significant financial difficulty" rather than actual default.

18. That said, both the IASB and the FASB are convinced that we need a more forward-looking impairment model and the Boards have been working to develop an expected loss model. It is unfortunate that, after extensive work, the two Boards have been unable to agree on a converged proposal[12], but we will both shortly be publishing for public comment our respective proposals and seeking the views of constituents on them. Both Boards are acutely conscious of the need to make progress as quickly as possible on this important, but complex, issue.

19. The IASB believes that the introduction of an expected loss model will be a major improvement, for three reasons[13]. First, it should lead to provisions being made in a more timely and realistic fashion and a heightened, more forward-looking risk awareness in the financial industry. Secondly, a timely clean-up of the banking system should free up resources to viable sectors of the economy instead of exercising forbearance on essentially defunct companies. Thirdly and perhaps most importantly, is the damage to the credibility of the financial sector by the serial underestimation of the true magnitude of problematic assets. Partial recognition of inevitable losses may buy time in the short run, but in the end leads to round after round of 'definitive' rescue programmes and a gradual erosion of confidence in the markets.

20. It is obvious that for a rigorous and adequate application of the expected loss model, banks need to be properly capitalised, which is an issue the prudential regulators are seeking to address through the recent reforms of the Basel regime for capital requirements.

Q12 What is the best method of accounting for profits and losses in trading instruments? Are there any alternatives to mark-to-market or mark-to-model that might better represent a 'true and fair view'?

[11] As acknowledged in a speech by IASB Chairman Hans Hoogervorst at the 3rd ECB Conference on Accounting, Financial Reporting and Corporate Governance for Central Banks, 4 June 2012 http://www.ifrs.org/Alerts/Conference/Pages/Hans-speech-4-June-2012.aspx.

[12] The IASB is proposing a 'three-bucket' approach, where an entity recognises a lifetime expected loss if credit quality and deterioration criteria are met, and a 12 month expected loss allowance for all other assets; the FASB approach is propose a model that reflects all credit risk in the portfolio at each reporting date, with impairment losses recognised when an entity originates or purchases a financial asset at fair value.

[13] As set out in Hans Hoogervorst's speech to the ECB, referenced in footnote 11.

21. For many financial instruments that are traded, there is no alternative to fair value. This was a point made in evidence to the Parliamentary Commission by both Hermes Equity Ownership Services and the Investment Management Association. IAS 39 requires that derivative financial instruments be recognised and measured at fair value as they are typically issued at a small cost, or even at zero, but they may have a significant value subsequently and at settlement. Applying a cost approach to their measurement would not reveal that potential impact to investors.

22. However, the global financial crisis highlighted the need for:

(a) clarifying how to measure fair value when the market for an asset or liability becomes less active; and
(b) improving the transparency of fair value measurements through disclosures about measurement uncertainty.

23. The IASB and FASB worked together to respond to these needs. In May 2011, the IASB issued IFRS 13 *Fair Value Measurement*, which explains how to measure fair value for financial reporting. IFRS 13 will help increase transparency when entities use models to measure fair value, particularly when users need more information about measurement uncertainty, such as when a market becomes less active. The standard requires entities to disclose information about the valuation techniques and inputs used to measure fair value, as well as information about the uncertainty inherent in fair value measurements. The IASB believes that providing additional information about fair value measurements to users of financial statements will help improve confidence in those measurements, especially those at 'Level 3' of the fair-value hierarchy, which relies on unobservable inputs for the asset or liability, including an entity's own data. That said, few banks make extensive use of Level 3. Research undertaken by JP Morgan Cazenove of the 2011 Annual Reports of European banks[14] reveals that, on an unweighted average basis, Level 3 assets represented around 3 per cent of financial assets. Of the major UK banks, Barclays had the highest proportion, with 4 per cent.

Q14 Do we need a separate accounting regime for banks? If so, what should it look like?

24. The IASB has always advocated financial reporting requirements that account for transactions and activities across industries, rather than developing industry-specific guidance. We believe that such as approach avoids the proliferation of potentially conflicting industry-specific requirements. In a recent report[15], the IFRS Foundation staff noted that, 2008, the US Securities and Exchange Commission (SEC) published the findings of the Pozen Report[16], which recommended that industry guidance should be eliminated from US GAAP to reduce avoidable complexity. The Pozen Report went on to recommend that the SEC should encourage the IASB to limit future industry-specific guidance.

[14] JP Morgan Cazenove (August 2012) – Europe Equity Research 'Financial Instruments disclosure analysis'.

[15] IFRS Foundation (October 2012) 'Report to the Trustees of the IFRS Foundation: IFRS Foundation staff analysis of the SEC Final Staff Report – Work Plan for the consideration of incorporating IFRS into the financial reporting system for US issuers' http://www.ifrs.org/Alerts/PressRelease/Pages/IFRS-Foundation-Staff-Analysis-of-SEC-Final-Staff-Report-on-IFRS.aspx.

[16] Report of the Advisory Committee on Improvements to Financial Reporting to the US SEC (August 2008) http://www.sec.gov/about/offices/oca/acifr/acifr-finalreport.pdf

25. That said, while the IFRSs on financial instruments are applicable to all entities that have financial assets and financial liabilities, they have particular relevance for the financial statements of financial institutions, including the banks. These standards have been written with what their effects on the banking industry will be very much in mind. For example, much of the IASB's outreach in developing its proposals on impairment has been with the financial sector and its prudential regulators, particularly through an enhanced dialogue with the FSB and the Bank for International Settlements. As the report of the Financial Crisis Advisory Group (FCAG)[17] made clear, "prudential regulators could benefit from the insight of accounting standard setters in making regulatory requirements (such as the Basel ratios) more transparent", although the FCAG cautioned that such requirements must be made in a manner that does not compromise the transparency and integrity of financial reporting.

26. We note that the final report of the Sharman Inquiry[18], launched by the UK FRC in 2011, addressed the issue of whether there should be a separate financial reporting and auditing regime for banks. The report noted that most commentators to the Inquiry thought that, as financial reporting and auditing standards have been developed in order to be applicable to all types of business, no separate industry specific standards should be developed as this would restrict the comparability of financial reports. As some groups of companies have banking components as well as businesses in other sectors, the Sharman report observed that "it may be problematic to draw boundaries around the entity to be reported separately".

27. It was also pointed out to the Panel of Inquiry that the growing regulatory requirements already offer the potential to develop an incremental (if not separate) financial reporting and auditing regime through the regulatory returns that are required. For example, the regulator has the ability to require banks to provide incremental information that may also be relevant to the markets.

28. We agree with the views reported in the Sharman Report.

Q15 Are there any interim measures (such as mandatory disclosure) which could be introduced in the meantime?

29. On 29 October 2012 the FSB, of which the IASB is a plenary member, announced the publication of the Report of the Enhanced Disclosure Task Force (EDTF)[19]. The EDTF was formed at the initiative of the FSB in May 2012 to investigate ways in which to improve the quality of risk disclosures for banks. The Report includes a number of recommendations aimed at enhancing the clarity, comparability and timeliness of information that banks provide to their investors. The IASB has commended the issue of this Report as complementing our own efforts to enhance transparency and the usefulness and comparability of financial statements. Furthermore, the IASB has recently

---

17 The FCAG was a high-level group, formed at the request of the IASB and the US FASB, to consider financial reporting issues arising from the crisis. Its' report was published in July 2009: http://www.ifrs.org/News/Press-Releases/Pages/Financial-Crisis-Advisory-Group-publishes-wide-ranging-review-of-standard-setting-activities-followi.aspx.

18 The Sharman Inquiry (June 2012) 'Going Concern and Liquidity Risks: Lessons for Companies and Auditors – Final Report and Recommendations of the Panel of Inquiry' http://www.frc.org.uk/getattachment/591a5e2a-35d7-4470-a46c-30c0d8ca2a14/Sharman-Inquiry-Final-Report.aspx.

19 Financial Stability Board (October 2012) 'Enhancing the Risk Disclosure of Banks: Report of the Enhanced Disclosure Task Force' http://www.financialstabilityboard.org/publications/r_121029.pdf

started a revision of its Conceptual Framework and will consider the EDTF recommendations as it develops new financial reporting disclosure principles

21 December 2012

Written evidence submitted by Professor Prem Sikka, Centre for Global Accountability, Essex Business School, University of Essex

Introduction

This submission is a response to the request by the Parliamentary Commission on Banking Standards (PCBS) for evidence on matters relating to tax, audit and accounting.

The banking crash is not only a crisis for the financial sector, but also for the social and political institutions charged for securing accountabilities. These also include accounting and auditing, which supposedly enable external parties to make some sense of the risks.

A brief overview of the submission is as follows:

- This submission argues that the auditing industry has failed in its duty to give an honest and truthful opinion on the accounts published by banks. It argues that private sector audit firms should not continue to audit banks. That function should be performed by a state designated regulator.
- It notes the involvement of accounting firms in anti-social practices and their tendency of non-cooperation with regulators investigating banking frauds.
- It urges the banking regulator to set accounting and auditing standards for banks, all subject to a parliamentary scrutiny.
- This submission argues that the public has the right to know of any arrangements between banks, auditors and regulators and thus opposes the wall of secrecy that is erected around dialogue.
- It calls for withdrawal of tax relief on interest payments by banks on their borrowing as that amounts to a public subsidy and encourages excessive leverage.
- It calls for executive remuneration to be linked to a wider measure of performance, which takes account of investment, job creation, providing finance to emerging businesses, staff training, staff retention, staff welfare, maintaining branch networks, customer satisfaction and freedom from regulatory action.
- It calls for bank employees, depositors and borrowers to vote on executive remuneration.
- It calls for publication of the tax returns of banks and greater public information about their operations. For example, by embracing Country-by-Country reporting which would require banks to show assets, liabilities, profits, losses, taxes, employees for each country of their operation.

1. How, if at all, does the tax system encourage leverage in banks? What is the effect of having tax relief for debt interest but not for dividends on equity? What effect does this have on the stability of the banking system?

1.1. Tax relief on corporate borrowings is a key factor in leverage. Well known theories of capital structures in the corporate finance literature have shown that tax relief reduces the weighted average cost of capital. Consequently, equity holders enjoy a higher rate of return, but it takes no account of the social consequences or any implications for the stability and integrity of the financial system. The pursuit of higher rates of return for shareholders has persuaded banks to take on excessive leverage. This makes them vulnerable. Just before its demise Lehman Brothers had a leverage ratio of just over 30. This means that a negative change of just over 3% in underlying assets would have wiped out its entire equity. Similarly, Bear Stearns had a gross leverage ratio of 33 and it was not able to withstand the shocks either. Higher leverage reduces a bank's ability to absorb shocks, deal with bad debts, toxic assets and maintain its capital.

1.2. How returns are packaged in the form of dividends to equity holders or as interest payments to debt holders does not make any difference to the underlying systemic risks. Dividend and interest payment are simple division of operating profits. They are not a business expense and neither should qualify for any tax relief.

1.3. The interest paid on corporate borrowings should not qualify for tax relief. This already applies to individuals and should also apply to companies. The tax relief on interest payment effectively gives a public subsidy to banks and other corporations. It increases the return on equity, often a variable in executive remuneration. Safety and integrity of the financial system should take precedence over bank profits.

1.4. Banks should build their capital through control of executive remuneration, bonuses and dividends. Whether equity of debt is used to finance assets should be governed by commercial considerations rather than tax subsidies on the payment of interest.

2. What are your views on alternative systems to level the playing field?

2.1. Alternative structures for banks can reduce pressures for ever rising profits and financial and tax arbitrage. For example, retail banks could be owned by employees, they could become co-operatives and some can return to a mutual structure. This would reduce incessant market pressures for higher returns and lets employees, customers and depositors be the judges of bank performance. Market pressures for short-term profits are also a key driver for tax avoidance. Past experience suggests that mutuals were less prone to higher leverage and tax avoidance.

2.2. The proposals for a Common Corporate Tax Base (CCTB) proposed by the European Union have a capacity to reduce organised tax avoidance. This has much in common with formulary apportionment system operated in the US and checks some of the avoidance schemes, especially when corporations are resident in low tax states (e.g. Delaware) but the economic activity is in a different place (e.g. California). Such a system can be tested on banks.

3. Do banks' attitudes to tax planning affect banking standards and culture, and does this have any effect on the wider economy?

3.1. Tax planning has become a euphemism for tax avoidance and even tax evasion. In an environment of unrestrained entrepreneurial capitalism, banks and major companies are willing to bend the rules to make profits at almost any cost. They have constructed elaborate organisational structures to achieve the outcomes. The shame is no longer in being caught or even paying the fines as fines have become just another part of the business cost and are in any case passed on to the innocent consumer. There are virtually no penalties on directors or designers of the tax avoidance schemes.

3.2. Banks avoid not only taxes on their own profits through complex corporate structures, joint ventures and special purpose entities, but also work with other financial intermediaries (e.g. accountants) to enable other entities and rich individuals to avoid taxes. A key motive is profits and people are often incentivised to sell tax services to generate revenues. The avoidance of taxes inevitably shifts the tax burdens and successive governments have shifted taxes to labour, consumption and savings. Ordinary people and responsible businesses are either forced to pay higher taxes or forego public goods.

3.3. There is little public information about the internal culture of banks though they have elaborate offshore structures. For example, Barclays has more Cayman Islands subsidiaries than any other FTSE 100 company. In 2009, The Guardian newspaper received and published a sheaf of internal memos from Barclay's structured finance department. These documents allegedly provided insights into Barclays' tax avoidance "knowhow" and "global expertise gained over several years"[1]. However, the bank obtained a court injunction and the documents were withdrawn from the newspaper's website. It is hoped

[1] The Guardian, Guardian loses legal challenge over Barclays documents gagging order, 19 March 2009 (http://www.guardian.co.uk/business/2009/mar/19/barclays-tax-guardian-injunction).

that the Commission would now ask to see those documents, and others, to enable it to make assessment of the internal culture of banks.

3.4. A glimpse of the internal culture at Barclays is provided by the action taken by HM Treasury in halting the bank's tax avoidance schemes. These were described by the Treasury[2] as "highly abusive" and "designed to work around legislation that has been introduced in the past to block similar attempts at tax avoidance". HM Treasury explained that the first scheme seeks to ensure that the commercial profit arising to the bank from a buyback of its own debt is not subject to corporation tax. In a bold step not previously taken by this Government, legislation is being introduced today that will not only prevent the scheme's use in the future, but will also act retrospectively to block its recent use by the bank that has disclosed the scheme and by any other company that has engaged in a similar scheme in the same period. The second scheme involves Authorised Investment Funds (AIFs) and aims to convert non-taxable income into an amount carrying a repayable tax credit in an attempt to secure 'repayment' from the Exchequer of tax that has not been paid".

3.5. The above shows that tax avoidance schemes cannot be designed without the appropriate organisational structure, culture, approval at the highest level and a supportive reward system. Profits through tax avoidance schemes are hard to maintain as the loopholes may be closed by the government, but that does not deter banks. Their annual accounts remain silent on the quality of profits, especially as gains from tax avoidance are not sustainable and can also result in prolonged investigations, litigation and fines, as evidenced by fines in relation to LIBOR manipulations.

3.6. The US Senate Permanent Subcommittee on Investigations has held hearings on some of the bank facilities offered through offshore entities[3] and exposed an organised culture of deceit and fraud that enabled wealthy US citizens to avoid/evade around $100 billion in taxes. The Senate report was particularly scathing about the role of UBS.

3.7. Another report from the same US Senate Committee examined tax avoidance/evasion on dividend payments[4]. This was facilitated by

---

[2] HM Treasury press release, Government action halts banking tax avoidance schemes, 27 February 2012 (http://www.hm-treasury.gov.uk/press_15_02.htm).
[3] US Senate Permanent Subcommittee on Investigations (2008), Tax Haven Banks and US Tax Compliance, Washington DC: US Senate.
[4] US Senate Permanent Subcommittee on Investigations (2009), Dividend Tax Abuse: How Offshore Entities Dodge US Taxes on US stock Dividends, Washington DC: US Senate.

banks, including those operating in the UK. The Committee noted avoidance was facilitated through the use of “a variety of complex financial instruments, primarily involving equity swaps and stock loans, these U.S. financial institutions structured transactions to enable their non-U.S. clients to enjoy all of the economic benefits of owning shares of U.S. stock, including receiving dividends, without paying the tax applicable to those dividends. These structured transactions increased the amount of dividend returns obtained by some of their non-U.S. clients by 30% or more ... evidence also showed that use of abusive dividend tax transactions is widespread throughout the offshore hedge fund industry. Offshore hedge funds actively sought these abusive transactions, negotiated the terms of the arrangements with the financial institutions, and at times played one financial institution against another to elicit the largest possible tax reduction”. The report also pointed to the role of accounting firms and other financial intermediaries.

3.8. In an ideal world, the US revelations should have promoted the UK government and parliamentary committees to investigate the UK-based banks, but there have been no inquiries.

4. Do you have any views on the role and purpose of structured capital markets teams in banks? Does the volume and type of structured tax transactions have any effect on bank stability, and did this play a part in the banking crisis?

No views are offered on this question.

5. What are your views on the effectiveness of the Code of Practice on Taxation for banks? Would the Code benefit from having sanctions and if so what should these be?

5.1. The Code was introduced as a result of Government concerns about banks engaging in tax avoidance, and undertaking transactions that they contend are within the letter of the law, but which are contrary to the spirit of the law. The consultation document explained how the Code would encourage all banks and organisations providing banking services operating in the UK to adopt best practice in relation to their tax affairs and to comply with the spirit, and not just the letter, of the law. In November 2010, the government announced that UK’s top fifteen banks have adopted the code.

5.2. The Code has been a failure. There has been no enforcement. Despite public revelations no banks has been punished and the government failed to devise any specific means of monitoring and public accountability. Taxpayers were not given any rights to check compliance or enforce the Code either. Banks have been serial offenders on tax matters. Here are a few examples:

- According to the US Senate Permanent Subcommittee on Investigations[5], major banks, including Deutsche Bank, HVB, UBS, and NatWest collaborated with KPMG and provided orchestrated loans for millions of dollars to enable the firm to design, market and implement tax avoidance. KPMG was fined $456 million after admitting "criminal wrongdoing[6]".

- Barclays Bank was told by the UK Treasury to pay £500m avoided tax. The government had to introduce retrospective legislation to deal with its schemes[7].

- HSBC is under investigation by HMRC for possibly facilitating tax evasion though its Jersey operations[8].

- With advice from Deloitte & Touche, RBS is accused of avoiding £500 million of taxes through complex avoidance schemes[9].

- Royal Bank of Scotland has been drawn into a criminal tax fraud investigation of its investment banking arm and involvement in tax avoidance[10].

---

[5] US Senate Permanent Subcommittee on Investigations, (2003). US Tax Shelter Industry: The Role of Accountants, Lawyers, And Financial Professionals - Four KPMG Case Studies: FLIP, OPIS, BLIPS and SC2, Washington DC: USGPO; US Senate Permanent Subcommittee on Investigations (2005). The Role of Professional Firms in the US Tax Shelter Industry, Washington DC: USGPO

[6] US Department of Justice press release, KPMG to Pay $456 Million for Criminal Violations in Relation to Largest-Ever Tax Shelter Fraud Case (http://www.justice.gov/opa/pr/2005/August/05_ag_433.html

[7] BBC News, Barclays Bank told by Treasury to pay £500m avoided tax, 28 February 2012 (http://www.bbc.co.uk/news/business-17181213).

[8] The Guardian, HSBC Jersey accounts investigated by UK tax authorities, 9 November 2012 (http://www.guardian.co.uk/business/2012/nov/09/hsbc-jersey-accounts-uk-tax-hmrc).

[9] The Guardian, RBS avoided £500m of tax in global deals, 13 March 2009 (http://www.guardian.co.uk/business/2009/mar/13/rbs-tax-avoidance).

[10] The Daily Telegraph, RBS staff held in tax fraud investigation, 11 February 2012 (http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/9076563/RBS-staff-held-in-tax-fraud-investigation.html).

- Royal Bank of Scotland (RBS) and Goldman Sachs were direct participants in an Ernst & Young marketed scheme to enable Prudential Plc to avoid taxes[11].

- UBS has paid a fine of $780 million for facilitating tax evasion in the US[12].

- Deutsche Bank[13] used an avoidance scheme designed by Deloitte to enable its staff to avoid income tax and National Insurance Contributions (NIC) on bonuses.

- Citigroup and Bank of America, with a combined $8 billion of pretax earnings in 2009 and 2010, each paid zero US corporate taxes two years in a row[14]

5.3. It is hard find many banks that have honoured the spirit of the Code. The following sanctions and reforms would be helpful.

- Banks indulging in tax avoidance should lose their deposit-taking licence. This licence is part of a social contract that enables banks to operate. In return, society has the right to expect ethical conduct. Those failing to fulfil their part of the social contract should lose the privileges.

- All bank tax returns and related documents should be publicly available so that citizens can monitor the tax behaviour of banks and also alert HMRC of possible tax avoidance schemes.

- Banks engaged in tax avoidance should not be given any publicly funded contracts.

- Fines for tax avoidance should be levied not only on banks but also from their directors and promoters of the avoidance schemes.

---

[11] As per Prudential Plc v Revenue & Customs [2007] UKSPC SPC00636 (http://www.financeandtaxtribunals.gov.uk/judgmentfiles/j3463/Spc00636.dOc)

[12] US Department of Justice press release, UBS Enters into Deferred Prosecution Agreement, 18 February 2009 (http://www.justice.gov/opa/pr/2009/February/09-tax-136.html).

[13] Deutsche Bank Group Services (UK) Ltd v Revenue & Customs [2011] UKFTT 66 (TC).

[14] Nation of Change, Who takes the Gold for Tax Avoidance in 2011, 9 April 2012 (http://www.nationofchange.org/who-takes-gold-tax-avoidance-2011-1333979061)

- The financial statements published by banks should state the profits made from tax avoidance.

6. How effective has the Senior Accounting Officer legislation been with particular regard to banking standards and culture?

6.1. The Senior Accounting Office (SAO) legislation was introduced in 2009 and requires large companies to appoint an SAO to strengthen its internal controls in relation to tax accounting matters.

6.2. In view of the newspaper headlines about organised tax avoidance (for example, relating to Barclays Bank) the success of this legislation must be doubted. The difficulty is that banks are under constant pressure to report higher short-term profits. Stock markets exert pressures for higher profits. The typical tenure of a CEO of FTSE250 companies is about four years and shrinking. In that period they need to build their CV and maximise personal financial rewards. Tax avoidance has been a comparatively easy way for them to increase profits and also appease stock markets. Increased monitoring by HMRC may have identified errors and possibly dissuaded some from indulgence in tax avoidance schemes, but has not curbed avoidance. A recent report by the National Audit Office stated that HMRC were examining 41,000 tax avoidance schemes.

6.3. A major problem is that successive governments have opted for softer options rather than investigation, enforcement and punishment.

7. Do we need a special tax regime for banks? If so, what would this look like and what would be priorities for change? Should tax continue to follow accounting with respect to banks? Should the tax system actively seek to influence banking standards and culture?

7.1. Banks do not need a special tax regime. Their compliance with the rules should be enforced. Their abuses should be investigated. Details of any tax avoidance schemes filed with the DOTAS regime should be publicly available. Details of any tax avoidance scheme developed and marketed should be publicly available. Where the tax tribunals and courts rule against a tax avoidance scheme in which a bank has participated then a fine equivalent to ten times the amount of tax involved should be levied on the bank. Its directors should be required to provide a written explanation of why they entered into such a scheme and the steps they have taken to ensure that such behaviour is not repeated.

7.2. The divergence between accounting and tax rules is a source of problems. The tax system is created by democratic consent. It is enforceable and violation can lead to criminal penalties. The accounting standards are created by private interest organisation, lacking in democratic mandate. Their violations are not enforced by any government department and rarely carry any criminal penalties. In principle, the Financial Reporting Review Panel (FRRP) can force companies to correct defective accounts, but has always missed the bigger picture. Despite publishing dubious accounts no bank has ever been required to correct its accounts.

7.3. Accounting and taxation rules should be aligned. This reduces the learning costs and enhances compliance and enforcement. This would enhance public accountability in that a Minister and Parliamentary Committee would design and refine the rules. The abuses would be punishable by law. Even if Parliament delegates some such powers to another agency, Ministers can be called to account. Currently, no Minister has assumed responsibility for defective accounting rules.

7.4. The culture f banks can be changed through greater public availability of information. For example, Country-by-Country reporting can shed light on the shifting of profits and thus enable the public to ask pertinent questions.

8. Are banks exploiting regulatory and information arbitrage between FSA, HMRC and auditors? If so, what is needed to address this?

8.1. For the reason explained below, we do not have confidence in auditors. They are required to state whether the accounts show a ‘true and fair’ view. This requirement overrides compliance with the Companies Acts and IFRSs. This means that any material information which is appropriate for understanding the financial statements should be published. The amounts of tax avoidance are material (for example, the £00 million avoidance scheme operated by Barclays) and have a significant bearing on the quality of profits, likelihood of litigation, public opprobrium and business reputation. Yet, it is hard to think of even one example, where the bank involved has published any information about tax avoidance, or where the absence of this vital information has resulted in the issuance of a qualified audit opinion. Auditors are aligned with the banks and do have failed to provide an effective check on their excesses.

8.2. FSA has clearly failed to effectively regulate banks. The revolving doors have not helped as bank executives have been parachuted into senior regulatory position. Psychologically their sympathies have been with the banking industry though after the banking crash many have been busy reinventing themselves. Banks have lunch-table and other meetings with regulators and there is virtually no public information about discussions or any deals.

8.3. HMRC is poorly equipped to deal with tax avoidance. Low pay and morale means that many able people leave and are captured by the tax avoidance industry. This inevitably creates opportunities for banks and other tax avoiders. HMRC will probably never be able to match the resources commanded by banks and other large corporations. Therefore, more attention needs to be paid to redesigning the tax system, enforcement and public availability of information

9. **Should there be a 'safe environment' in which the tax authority, regulator and auditors can share confidential information and concerns, possibly on varying levels of seniority?**

9.1. There are problems with the notion of 'safe environment' as it seems to elevate secrecy over public accountability. Greater emphasis should be placed on the public's right to know about banking practices, abuses, regulatory action and any tax deals. The danger is that behind closed doors some elites will discuss matters of public interest and make mutual concessions without any public accountability. Such arrangements thwart public debate and the development of effective legislation.

9.2. It is salutary to look at a couple of examples of chaps talking to other chaps culture that is so corrosive and deeply embedded in the UK regulatory circles.

9.3. Former Nigerian dictator General Sani Abacha laundered his loot through 42 bank accounts in the UK[15]. Yet unlike the Swiss authorities, neither the FSA nor the Treasury has publicly named any of these banks. Thus the public is not in a position to ask questions about the integrity of banks and regulatory system. The political protection encourages banks to be even more reckless and may have encouraged the involvement of Standard Chartered Bank and HSBC in money laundering. It is noticeable that the recent exposure of LIBOR abuses by Barclays and the involvement of UK banks in money laundering primarily came from the US rather than the UK regulators.

9.4. The so-called "safe environment" works against the public interest. It makes regulators too comfortable and even parliamentary committees are kept in the dark. A brief overview of the closure of Bank of Credit and Commerce International would be a good reminder.

9.4.1 In July 1991, Bank of Credit and Commerce International (BCCI) was closed by the Bank of England (BoE). It was the biggest banking fraud of the twentieth century. For many years before its closure, BCCI engaged in fraudulent activities, but the BoE did nothing. By the early 1980s, there was some unease at the Bank of England about BCCI's operations. In 1982, an

[15] See UK Africa All Party Parliamentary Group, (2006), The Other Side of the Coin: The UK and Corruption in Africa, AAPPG, London.

internal Bank of England memo described BCCI as "on its way to becoming the financial equivalent of the Titanic[16]", in a supposedly safe environment the BoE did little. According to New York District Attorney Robert Morgenthau[17], who mounted a number of criminal prosecutions, BCCI operated corruptly for 19 years prior to its closure. It systematically falsified its records, laundered the money of drug traffickers and other criminals. It paid kickbacks and bribes to public officials. BCCI had links with senior government officials in many countries. It handled money transfers for dictators, such as Saddam Hussein, Manuel Noriega, Hussain Mohammad Ershad and Samuel Doe. It provided accounts for the Medellin Cartel and Abu Nidal.

9.4.2 A US Senate Committee investigated the BCCI frauds[18] and was highly critical of the Bank of England, then the statutory regulator of UK banks, and again being reincarnated in that capacity. The report stated that “In April, 1990, the Bank of England reached an agreement with BCCI, Abu Dhabi, and Price Waterhouse to keep BCCI from collapsing. Under the agreement, Abu Dhabi agreed to guarantee BCCI's losses and Price Waterhouse agreed to certify BCCI's books. As a consequence, innocent depositors and creditors who did business with BCCI following that date were deceived into believing that BCCI's financial problems. From April, 1990, the Bank of England relied on British bank secrecy and confidentiality laws to reduce the risk of BCCI's collapse if word of its improprieties leaked out. As a consequence, innocent depositors and creditors who did business with BCCI following that date were denied vital information, in the possession of the regulators, auditors, officers, and shareholders of BCCI, that could have protected them against their losses.

9.4.3 On page 276 of its report the US Senate Committee stated that Bank of England was engaged in a “cover-up” “By agreement, Price Waterhouse, Abu Dhabi, BCCI, and the Bank of England

[16] This is from a document obtained by BCCI’s liquidators for litigation against the Bank of England. The quote was reported in The Independent, 13 January 2004; http://www.independent.co.uk/news/business/news/bank-of-england-inthe-
dock-over-bcci-collapse-572886.html

[17] As per US Senate Foreign Relations Subcommittee on Narcotics, Terrorism and International Operations, The BCCI Affair: Hearings Part 1 – August 1, 2 and 8 1991, Washington DC: US Senate Committee on Foreign Affairs

[18] Chapter 1 of the United States Senate Committee on Foreign Relations, *The BCCI Affair: A Report to the Committee on Foreign Relations* by Senator John Kerry and Senator Hank Brown, December 1992. Washington: USGPO

had in effect agreed upon a plan in which they would each keep the true state of affairs at BCCI secret in return for cooperation with one another in trying to restructure the bank to avoid a catastrophic multi-billion dollar collapse. Thus to some extent, from April 1990 forward, BCCI's British auditors, Abu Dhabi owners, and British regulators, had now become BCCI's partners, not in crime, but in coverup. The goal was not to ignore BCCI's wrongdoing, but to prevent disclosure of the wrongdoing from closing the bank. Rather than permitting ordinary depositors to find out for themselves the true state of BCCI's finances, the Bank of England, Price Waterhouse, Abu Dhabi and BCCI had together colluded to deprive the public of the information necessary for them to reach any reasonable judgment on the matter, because the alternative would have been BCCI's collapse".

9.4.4 The BoE decision to close BCCI was based on a report that it commissioned from Price Waterhouse in March 1991. This report was prepared under Section 41 of the Banking Act 1987 and codenamed "The Sandstorm Report". The cost was borne by the UK taxpayer. The report was never finalised but an interim draft was submitted to the Bank of England on 24 June 1991 and few days later BCCI was closed. In the UK, the "Sandstorm Report" was considered to be a secret report, but a censored version eventually reached the US Senate Committee investigating BCCI's operations. Later on, the Committee noted that "shortly before the conclusion of the preparation of this report in late August 1992, the Subcommittee obtained an uncensored version of the report from a former BCCI official, which revealed criminality on an even wider scale than that set forth in the censured version".

9.4.5 BCCI closure has been the subject of a number of reports by various UK parliamentary committees[19]. However, unlike the US

[19] For example, United Kingdom Treasury and Civil Service Select Committee (1991), *Banking Supervision and BCCI: The Role of Local Authorities and Money Brokers*, London: HMSO; United Kingdom Treasury and Civil Service Select Committee (1992), *Banking Supervision and BCCI: The Response of Bank of England to Second and Fourth Reports from the Committee in Session 1991-92*, London: HMSO; United Kingdom *Treasury and Civil Service Select Committee (1992), Codes of Practice and Related Matters*, London: HMSO; United Kingdom *Treasury and Civil Service Select Committee (1992), Banking Supervision and BCCI: International and National Regulation,* London:
HMSO; United Kingdom *Treasury and Civil Service Select Committee (1992) Banking Supervision and BCCI: International and National Regulation,* London:

Senate hearings none are thought to have had access to the full or even censored version(s) of the Sandstorm Report for their deliberations.

9.4.6 The UK government did not release the Sandstorm Report, even though a censored version was given to the US Federal Reserve and passed on the US Senate Committee. This censored version, which later turned out to be about 99% of the Sandstorm Report was placed in the US Congress Library. The same version has remained a state secret in the UK. The BoE had carefully removed the names of wrongdoers, possibly to protect politicians, wealthy elites and the UK arms trade with Middle East countries. There was little regard for the interests of the UK citizens.

9.4.7 Faced with public pressure to know more the then Prime Minister John Major informed the House of Commons that Lord Justice Bingham will prepare a report not on the banking frauds, or how they continued, but solely on the supervisory role of the Bank of England. Lord Justice Bingham was not allowed to interview any official of BCCI, but the Prime Minister stated that he "will have access to all relevant papers, officials and Ministers. Nothing and no one will be held back. I assure the House that any relevant matter of any sort will be made available to Lord Justice Bingham. The conclusion of the inquiry will be made public … I shall publish the results of the inquiry as soon as Lord Justice Bingham presents them to me[20]". However, the complete document was never published. The appendices containing extracts from the Sandstorm Report were excised from the Bingham Report[21], and some 21 years later still remain unpublished.

9.4.8 In 2005, following the enactment of the Freedom of Information (FOI) legislation, the Treasury was asked to release the Sandstorm Report. It refused. The refusal was taken up with the Information Commissioners. He eventually sided with the Treasury. In July 2011, after some five and half years of protracted legal battle, the Treasury was ordered by three judges to release most of the missing information[22]. It is worth

---

HMSO.

[20] Hansard, House of Commons Debates, 22 July 1991, col. 755, 761

[21] Bingham, The Right Honourable Lord Justice (1992), Inquiry into the Supervision of The Bank of Credit and Commerce International, London: HMSO.

[22] Professor Prem Sikka v The Information Commissioner and the Commissioner of Her Majesty's Treasury, available at

bearing in mind that the Treasury was preventing the release of information which was over twenty years old and most of it was sitting in the US Congress Library.

9.4.9 The release of the missing information showed that the Treasury and the BoE had covered up the names of many wrongdoers, which included members of the Royal family of Abu Dhabi, wealthy elites, politicians and other well connected individuals. The Sandstorm Report also raised questions about the role of auditors. Arguably, its concealment stifled public debate and also did not enable parliament to design good banking laws.

9.4.10 Despite losing the court case, the Treasury has failed to make the Sandstorm Report publicly available. Its duty under the FOI is fulfilled by providing a copy to the litigant. It is content to keep the public in the dark[23].

There is little evidence to suggest that the UK regulatory culture has changed and we are suspicious of any “safe environment” which can become a licence to keep the public in the dark.

10. **What was the role of accounting standards and reliance on fair value principles in the banking crisis? What does a ‘true and fair view’ really represent to the market?**

10.1. One of the most disturbing things in the current crisis has been the position taken up by accounting standard setters, accounting firms and the accounting industry generally. Their mantra is that accounting rules have had no impact on the crisis. This bizarre argument does not explain why if accounting is so insignificant do companies and accounting firms spend time lot of producing financial statements or dominate the production of accounting standards through the IASB and other standard setters. If it is so insignificant why does accounting matter to business operations? How can any accounting rule be produced if it is not written with some outcomes in mind?

10.2. The accounting industry has reached a conclusion that it is not accountable for the consequences of the rules produced by it. But somehow banking and other regulators are the ones accountable for what accountants are supposed to do, or have done. If so, there is no justification for having any accounting standard setting structure.

---

http://www.informationtribunal.gov.uk/DBFiles/Decision/i544/20110909%20Decision%20and%20Conf%20Sch%202.pdf

[23] The report can be seen on a non-government website (http://visar.csustan.edu/aaba/BCCISandstormRelease.html)

Market failure, according to the IASB, FRC and others, is apparently not accounting's fault; instead, regulators failed, which is a particularly disingenuous claim coming from an intellectual tradition of rather dogmatic insistence that the less regulation is somehow better for everyone, or that accounting rules designed by insiders (accounting firms and corporations) are the way forward. The position taken up by the accounting industry is that society should continue to give it privileges, status and niches even though accountants accept no responsibility when people rely to their detriment on accounting's product.

10.3. An important lesson for accounting from the current financial crisis is that financial markets are not natural constants that produce outcomes we all must accept because they follow some natural laws. Merely serving the needs of investors and creditors in financial markets without any attention being paid to where the boundaries of those markets are drawn and what their consequences are is a key reason for the crisis and accounting's role in that crisis.

10.4. Financial accounting has stepped into arenas, which is not fit for. It claims to mimic economics but a view is that "Economics, as it has been practiced in the last three decades, has been positively harmful for most people[24]". Now how can accounting deliver positive results about economic phenomena when the underlying activity is harmful? There little consideration of economic developments by accounting regulators.

10.5. The shift from industrial capitalism to finance capitalism and the accompanying growth in the use of complex financial instruments has been treated by accounting standard setters as a technical valuation issue. The wisdom is that all that you need to do is to discount future cash flows or build models and all will be well even though there is little chance of being able to ascertain their current value. Accounting standard setters, borrowing from neoclassical economic theories, have prescribed complex rituals to assign values based on uncertain future outcomes, which then have an aura of exactness and masquerade as an objective measures.

10.6. The key question should be whether such complexity and reckless gambling (often implicit in derivatives) should exist at all? The marketing of medicines requires rigorous checks to consider their harm potential. The seller must demonstrate the social benefits, but financial instruments can be marketed, packaged, sliced and diced without any

[24] Chang, H.J. (2010). 23 things they don't tell you about capitalism. New York: Bloomsbury Press.

checks on their potential for harm. No accounting standard setter has ever alerted the public to the harmful potential of financial instruments, or the valuation methods advocated by it. This abdication of duty is complicit in the financial crisis. If the role of accounting is to call powerful corporations and economic interests to account then standard setters should have considered the harm that their rules would do. They should not be permitted to issue an accounting standard until those issues are addressed. But such issues have not received attention in the past and there is no sign that they will in the foreseeable future. Thus, we are left in ad hoc rationalisations and justification of fair value, mark-to-model/myth and other varieties of accounting.

10.7. The shift from stewardship accounting to market-based accounting has had profound influence on bank financial statements. Under the influence of Chicago economics, the view is that somehow company balance sheets should equate with market values of companies. This is not feasible. Accounting's adherence to economic myths cannot be claimed to have made accounting a particularly valuable social activity.

10.8. The links with market values inevitably import volatility to company accounts and also delay the recognition of losses. They also create panics, as evidenced by the loss of pension rights by millions of employees. The fair value of pension liabilities fluctuates and takes little account of the long-term position. In many cases, markets are thin and virtually non-existent and fair values of assets cannot really be found in any objective way. Therefore, models have been built to generate accounting numbers. The difficulty is that these numbers are not capable of verification, a traditional feature of financial reporting and auditing. The accounting numbers are just the outcome of a model rather than representative of some notion of historical cost, exit or entry values. The use of models has also changed the nature of accountants' craft. Rather than boasting some expertise on making judgements about valuations, accounts have now become slaves to a model. Rather than showing scepticism they are now focused on checking the assumptions built into models. Episodes, such as those relating to the demise of Long Term Capital Management (LTCM) show that even winners of the Nobel Prize in Economics could not build good economic models and their hedge fund collapsed. What chance is there that accountants can do better?

10.9. A 'true and fair' views sounds very persuasive, but in practice has been reduced to a box-ticking approach by accounting firms. 'True and fair' can invoke references to morality, justice, ethics, good, honourable and many other qualitative characteristics, but such matters rarely appear on the checklists used by accounting firms. The preparation and audit of company accounts has become a mechanical process. An engineer is unlikely to build a bridge without consulting research, but most accounting practitioners do not read any research papers. They have little interest in research. Their notion of research is primarily learning about the latest accounting standard rather than anything about the production of standards, choices of accounting, limitation of accounting and the crisis of banking or capitalism. Many of the accounting standards today advocate the use of discounted future cash flows (e.g. for financial instrument, pensions, leases). These approaches were advocated in scholarly journals over 50 years ago. Now, the accounting education process is mostly about learning the rules and with little emphasis on reflection. The result is that hardly any new ideas for tackling accounting challenges are emerging. Perhaps, markets are not really interested in any intricate meaning of 'true and fair' and are more preoccupied with the bottom line. If so, then it is for the regulators to ensure that company accounts do connect with socially desirable characteristics and accountants are equipped to meet those obligations.

11. **What are your views on the current incurred-loss impairment model and its role in the banking crisis? Do you consider that proposals to move to an expected-loss model will address criticisms of the current accounting rules?**

11.1. The incurred-loss impairment model seems to have been developed by the IASB without much public debate. The key idea is that toxic assets can only be written down when there is observable objective evidence that a loss has been incurred. The difficulty with this is that there can be various probabilities attached to the events that might lead to a loss and the outcome may not be certain for some time. Meanwhile balance sheets can continue to show an asset as good even though there is a good chance that it may become bad. The model does not enable banks to set aside profits or build reserves to cancel out toxic assets. The model also enabled banks to front-load income i.e. they could recognise interest income even though it has not yet been received. Any delays in receiving were merely treated as roll-overs, or deferments. Thus the model enabled recognition of higher income but low recognition of losses. This suited executives whose remuneration is linked to earnings as it enabled them to collect high bonuses.

11.2. A move to an expected-loss model may mitigate some of the problems of the incurred-loss model, but it needs to be accompanied by appropriate disclosures.

12. **What is the best method of accounting for profits and losses in trading instruments? Are there any alternatives to mark-to-market or mark-to-model that might better represent a 'true and fair view'**?

12.1. A return to 'prudence' can constrain premature recognition of profits and provision of anticipated losses. However, the approach also has the downside it may enable management to build big bath provisions and use them to smooth earnings. This should be accompanied by effective disclosures.

13. **Did IFRS accounting standards contribute to a box-ticking culture to the exclusion of promoting transparency and a 'true and fair view' of the business?**

13.1. The tick-box mentality is deeply embedded in accounting and auditing practices. It is encouraged by professional education. Accounting firms see the tick-box approach as a way of increasing efficiency i.e. the necessary tasks have been performed. Partners performing reviews of audit cannot replicate the field work to see that the necessary task have been carried out. The size and order of the file and related schedules rather than the quality of work impresses partners. Perhaps, with an eye on possible litigation and reviews by regulators they devote attention to compliance with accounting and auditing standards.

13.2. In this environment, IFRSs have further deepened a tick-box approach as accounting standards are often presented in a formulaic way. For example, there are tests to determine whether a lease is a finance/capital lease or an operating lease. Such an environment has constrained any scope for professional judgement.

13.3. 'True and fair view is often linked to notions of transparency. The notion of transparency is appealing but remains elusive. Each accounting standard is accompanied by the rhetoric of transparency but we are no closer to it today than in 1969 when the UK embarked on a programme of accounting standards. Despite a raft of accounting standards, Citigroup is estimated to have some $1.1 trillion of assets off balance sheet[25]. Banks had around US$5,000 billion of assets and liabilities off balance sheet (Financial Times, 3 June 2008). Some banks have shown assets, especially subprime mortgages, at highly inflated values

---

[25] Bloomberg, "Citigroup's $1.1 Trillion of Mysterious Assets Shadows Earnings", 14 July 2008 (http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a1IiVM3tG3aI).

and derivatives have long been a powerful tool for inflating company profits by hiding losses and hence the risks of company operations.

13.4. Even today, some five years after the banking crash, regulators have little idea of the exposure of banks and the risks to the entire financial system. Here is an exchange in the House of Commons:

Austin Mitchell: To ask the Chancellor of the Exchequer what the notional value of derivatives held by the banks regulated by the Financial Services Authority is; and what information is held about the maturity and exposure of such derivatives.

Greg Clark: This information is not currently available. The shortfall in information available to regulators on derivatives during the financial crisis led the G20 in 2009 to propose that all over the counter derivative trade information should be reported to Trade Repositories. This requirement, which is expected to enter into force in the EU by the start of 2013, will allow information on all derivatives trades to be made available to the relevant authorities.

(Source: Hansard, House of Commons Debates, 22 Oct 2012 : Column 619; http://www.publications.parliament.uk/pa/cm201213/cmhansrd/cm121022/text/121022w0001.htm).

13.5. Yet the missing assets, liabilities and derivatives exposure did not attract any opprobrium from auditors. A key element in this state of affairs is the control and colonisation of standard setting institutions and the economic interests of accounting firms. The Big Four accounting firms invest around $1.5 million each year in the IASB and major corporations also provide money. The payoff is friendly accounting standards whilst some issues are organised off the political agenda altogether. A good example is the neglect of the calls for Country-by-Country reporting and complete absence of standards that would require banks to provide information about tax avoidance schemes.

14. Do we need a special accounting regime for banks? If so, what should it look like?

14.1. Yes, we need a special accounting regime for banks.

14.2. It is very odd that regulators place reliance upon financial statements published by banks but do not set accounting standards for banks. In view of the shortcomings of IFRSs, it is doubtful that the financial statements result in prudent accounting. In addition, banks are also implicated in tax avoidance and operate through numerous offshore entities and special purpose vehicles to shift profits through transfer pricing and other strategies. The resulting financial statements are a poor vehicle for prudent banking or regulatory interventions.

14.3. Accounting standards for banks are now formulated by the International Accounting Standards Board (IASB). The IASB is a private sector organisation owned by a Foundation located in Delaware. This ownership structure enables it to avoid tax on its income. Such an organisation is unfit to make rules on accountability for others. The IASB is bankrolled by the Big Four accounting firms and major corporations, including banks. It lacks independence from the organised interests and has failed to introduce any standard that requires banks to come clean about their special vehicles, offshore structures or even their transfer pricing practices.

14.4. There is also a divergence of opinion about the purpose of financial statements. The accounting standard setters (e.g. the IASB, FASB, ASB) argue that their purpose is to enable investors, creditors to make predictions about earnings, future cash flows and performance and seem to believe that balance sheets should represent the market value of the firm. This is an impossible aim as the contents of financial statements depend on political and economic vagaries of their time. In contrast to the direction of accounting standards, the 1990 House of Lords judgement in *Caparo Industries plc v Dickman & Others [1990] 1 All ER HL 568* stated

"I see no grounds for believing that, in enacting the statutory provisions [requiring publication of audited company accounts] Parliament had in mind the provision of information for the assistance of purchasers of shares or debentures in the market, whether they be already the holders of shares or other securities or persons having no previous proprietary interest in the company ...... For my part, however, I can see nothing in the statutory duties of a company's auditor to suggest that they were intended by Parliament to protect the interests of investors. ... I therefore conclude that the purpose of annual accounts, so far as members [shareholders] are concerned is to enable them to question the past management of the company, to exercise their 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. ... As a purchaser of additional shares in reliance on the auditor's report, he [the shareholder] stands no different from any other investing member of the public to who the auditor owes no duty".

14.5. Thus from auditing perspective company accounts are backward looking and have no relationship with any investment purpose, or protection of the public and are not designed to directly assist the regulators. It is difficult to see how the present form of financial statements can adequately assist regulators, markets and savers. There are a residue of past practices and need to be reconstructed.

14.6. Accounting and auditing rules for banks should be formulated by the banking regulators and approved by the relevant parliamentary committees. The committees can call for evidence on the appropriateness of the proposed rules. The rules can develop particular measures of capital, leverage and other key variables. They can require disclosures about the quality of profits and whether they are sustainable. For example, for the last five years of its life Bear Stearns profits came almost exclusively from speculative activities. No organisation can continue to pick winners indefinitely. Yet the quality of profits did not result in any red flags from auditors and the rules did not require any commentary form directors either.

15. **Are there any interim measures (such as mandatory disclosure) which could be introduced in the meantime?**

15.1. Yes. All banks should be required to adopt Country-by-Country (CbC) reporting. Under this, banks would be required to publish a table showing the assets, liabilities, profits, losses, taxes and employees, etc. for each country of their operation. All organisations already have this information. Thus, the cost of producing the information is very low. The current segmental reporting accounting standard (IFRS 8) does not provide such information and in any case leaves management to decide the material segments. Consequently, little is known about the activities of banks in tax havens and the risks related to those activities.

16. **What are your views on current proposals for improving disclosure and dialogue (with particular reference to discussion papers issued by FSA/FRC)?**

16.1. The arrangements for a dialogue between auditors the financial regulators were introduced by the Banking Act 1987, as the then government sought to rebuild the reputation of the City of London. The dialogue has been surrounded by secrecy and has probably been poor.

16.2. The FSA/FRC discussion papers attach little weight to the oddities of the arrangements. Auditors are not directly appointed by the FSA and audit reports are not addressed to the FSA. Auditors owe a ‘duty of care’ to the company and not to any state designated regulator. It is too easy for present auditors to hide behind claims of a duty of 'confidentiality' to their client banks and thus limit the quality of dialogue.

16.3. Auditors insert disclaimers in audit reports. For example, they say that

"Under section 235(1) of the Companies Act 1985 (or "Under section 495(1) of Companies Act 2006") we have a duty as auditors to report on the annual accounts of the company. This duty only extends to a report to the members of the company as a whole and not to an individual shareholder or group of shareholders or to a third party. We cannot be held responsible by any third party who uses or places reliance on our opinion in order to make a decision to enter into any type of transaction with the company".

In the light of such clauses it is difficult to see how the banking regulators can place reliance on any dialogue with auditors. To be effective, financial regulators need to be able to act on a real time basis and need timely information, especially as instability in the financial sector can infect the whole economy. Therefore, ex-post dialogue is of little value.

16.4. The key step must be to eliminate accounting firms from the audit of banks and for regulators themselves to direct audit all banks on a real-time basis. This client/auditor interests and arguments about confidentiality will not obstruct effective regulation. This proposal also reduces the long chain of communication implicit in the FSA/FRC papers.

17. **Is there a problem arising from the difficulty of qualifying the accounts of a bank? Should auditors be able to 'grade' accounts – from AAA down? What would be the effect of this?**
18. **Should the scope of audit be widened so that auditors can better express a broader view of the business? For example should auditors comment specifically on issues such as remuneration policy, valuation models or risk?**

These two question seem to overlap and therefore addressed together.

18.1. The auditors are appointed to give an opinion, but they have continued to shirk their duties by pretending that they cannot qualify bank accounts because this would somehow result in a self-fulfilling prophecy and the bank receiving qualified audit opinion would somehow die. Let us look at the reverse of this. At the onset of the banking crash, all distressed banks received an unqualified audit opinion (see Appendix 1[26]). If audit opinions have this miraculous

[26] Sikka, P. (2009), Financial Crisis and the Silence of the Auditors, Accounting, Organizations and Society, 34(6/7): 868-873.

power of life and death then all the distressed banks should have continued unscathed. However, that was not the case. Most banks needed financial support from the state. Markets, investors and governments did not believe auditors, possibly because they have little confidence in the integrity and independence of auditors. It is disturbing that auditors have been paid vast sums to give an honest opinion and then failed to do so.

18.2. There is already a scope for auditors to issue a variety of opinions ranging from adverse opinion, disclaimers and emphasis of matter, depending upon the kind of material uncertainties and disagreements. Thus auditors can choose from various opinions. They can also speak at AGMs on any matter relating to financial statements and also have important statutory rights in relation to resignation and removal and can speak on matter relating to financial statements. The problem has been auditors have been unwilling to exercise their powers and inform the readers of accounts.

18.3. The grading of banks accounts into ‘AAA’ is a recipe for creative games and is undesirable. This will also raise questions about director duties. Does lower grade mean lower director obligations? It will deepen a box-ticking approach as inevitably there will be issues about what needs to be done to secure ‘AAA’, ‘AA+’ ‘AA-‘ and other varieties of grades. The subtleties of the games will be lost on the ordinary public and will not serve any purpose though the exercise will no doubt generate vast fees for accountancy firms branching out into this new form of consultancy.

18.4. One of the ironies of the auditing scene is that audit failures are rewarded with more fee earning opportunities. Auditors have failed to adequately discharge their duties, but they may now be asked to take on more tasks for even more fees. If the Commission’s proposals were to be enacted then an even higher proportion of the UK GDP will be invested in accountancy surveillance. With some 340,000 professionally qualified accountants, the UK already almost the highest numbers of accountants per capita in the world. This has neither resulted in good audits, good corporate governance nor good financial reports or freedom for tax avoidance, frauds and fiddles. It is really time to look for alternative reforms which can deepen democratic accountability and also wean the UK off its obsession with calling accountants to look at and report on everything. These would include

- Empowering bank employees, savers and borrowers to cast a binding vote on executive remuneration

- Public availability of the remuneration contracts.
- Remuneration contracts should not solely be based to financial performance as accounting numbers are highly malleable. Instead,

they should also take account of service to the community, maintenance of branch networks, fair access to finance by the less well-off, loans to SMEs, regulatory failures, etc.

- The models used by banks for valuation and risk assessments should be publicly available.

- Banks often rely on credit rating agencies to grade their financial products. Their models should also be publicly available.

- No bank should be able to launch any financial product without prior testing and the results of that should be publicly available.

- Bank directors should be held criminally liable for publishing misleading accounts.

18.5. It is difficult to have any confidence in the current auditing arrangements and it needs to be reconstructed. Piecemeal tinkering, as suggested by the Commission, will not be productive. The auditing model is broken, rooted in the era of industrial capitalism and is unfit for the era of finance capitalism where money travels instantaneously and the valuation of assets and liabilities is based on complex mathematical models which mimic markets. Nick Leeson, of Barings fame, has argued that neither the regulators nor the auditors understood the business models of banks.

18.6. Large accounting firms have been involved in money laundering[27], tax evasion/avoidance, bribery, corruption and operation of cartels[28]. One would have thought that in a civilised society such organisations lack the social, ethical and moral credentials to be a pillar in the regulatory arrangements. By what moral standard can their role in a rgewualtory system be protected, or enhanced?

18.7. Accounting firms have a history of non-cooperation with regulators investigating banking frauds.

---

[27] For some evidence see, Mitchell, A., Sikka, P. and Willmott, H. (1998). Sweeping it under the carpet: the role of accountancy firms in moneylaundering, Accounting, Organizations and Society, Vol. 23, No. 5/6, 1998, pp. 589-607.

[28] Sikka, P. (2008). Enterprise Culture and Accountancy Firms: New Masters of the Universe", Accounting, Auditing and Accountability Journal, Vol. 21, No. 2, 2008, pp. 268-295.

18.7.1 When a US Senate Committee investigating the BCCI frauds sought information from its auditors Price Waterhouse, the firm refused. The request was channelled through the New York office. The reply to the Senate Committee[29] was that "The main audit of BCCI was done by Price Waterhouse UK. They are not permitted, under English law, to disclose, at least they say that, to disclose the results of that audit, without authorization from the Bank of England. The Bank of England, so far -- and we've met with them here and over there -- have not given that permission. The audit of BCCI, financial statement, profit and loss balance sheet that was filed in the State of New York was certified by Price Waterhouse Luxembourg. When we asked Price Waterhouse US for the records to support that, they said, oh, we don't have those, that's Price Waterhouse UK. We said, can you get them for us? They said, oh, no that's a separate entity owned by Price Waterhouse Worldwide, based in Bermuda". The Committee was unable to secure co-operation from the UK firm.

18.7.2 The UK investigation of banking frauds has also been hampered by auditing firms. For many years, Barings' consolidated financial statements had been audited by the London office of Coopers & Lybrand (now part of PricewaterhouseCoopers). Its Singapore affiliate became auditor of BFS for the year to 31 December 1994. In 1992 and 1993 BFS was audited by the Singapore firm of Deloitte and Touche (D&T) and reported their findings to Coopers & Lybrand (C&L) in London for the purpose of its audit of the consolidated financial statements of Barings Plc. It should be noted that the audit opinion on consolidated financial statements was issued by C&L's London office and it "placed reliance on D&T's opinion in their audit of Barings' consolidated financial statements[30]".

The Bank of England explained that it was unable to fully investigate the auditing aspects because the auditing firms did not co-operate. Its investigators reported, "We have not been permitted access to C&L Singapore's work papers relating to the 1994 audit of BFS or had the opportunity to interview their personnel. C&L Singapore has declined our request for access,

[29] United States, Senate Committee on Foreign Relations (1992). The BCCI Affair: A Report to the Committee on Foreign Relations by Senator John Kerry and Senator Hank Brown, December 1992. Washington, USGPO.
[30] Bank of England, (1995). Report of the Board of Banking Supervision Inquiry into the Circumstances of the Collapse of Barings, London, HMSO.

stating that its obligation to respect its client confidentiality prevents it assisting us. …….We have not been permitted either access to the working papers of D&T or the opportunity to interview any of their personnel who performed the audit. We do not know what records and explanations were provided by BFS personnel to them. ……. [Consequently] we have not been able to review and conclude on the adequacy of the work performed by BFS's auditors …" (pages 15, 17,153, 158 of the Bank of England report; see footnote 30).

The above examples show that there are too many difficulties in securing information and co-operation from auditing firms. Little is known about the overall structure and control.

18.8. The private sector auditors of banks have failed. Despite queues outside Northern Rock and demise of many US banks, all major banks received unqualified audit opinions from PricewaterhouseCoopers, Deloitte & Touche, KPMG and Ernst & Young. Private sector auditors have a history of silence and are immersed in too many conflicts of interests, as evidenced by their silence at Barings, Bank of Credit and Commerce International (BCCI) and other debacles. Accounting firms have shown no interest in serving the public or the state.

18.9. The system for auditing banks needs to be redesigned.

The audits of all banks should be carried out on a real-time basis directly by the regulator, or an agency specifically created for that purpose. Thus auditors would not be selected by the auditee nor directly remunerated by the auditee. The state designated auditors would be funded by a levy on financial enterprises. Their work would be subject to an oversight by Parliamentary committees. Auditing standards would be approved by parliament. The objectives of the newly constituted auditors would be to safeguard the integrity of the financial system and protect the interests of taxpayers, depositors and borrowers rather than solely be concerned with the interests of the investors. The proposed arrangements would reduce enhance the regulator's knowledge base and capacity for timely interventions. In the era of instant movement of money ex-post audits are of little use. For ideological reasons, some would object to such as proposal, but auditing is simply a means to an end. That end is to secure confidence in the system and check poor banking practices. Some elements of this proposal were envisaged in the US in the aftermath of the 1929 Wall Street crash. The crash highlighted shortcomings of audits by the private sector auditors. Lynn Turner former chief accountant of the US

Securities Exchange Commission (SEC) explained[31] that "when the legislation creating the SEC was first drafted in the early 1930s, it included a provision making the SEC the auditor for public companies. Then, at the last minute, the legislation was changed. [. . .] Toward the tail end of the Congressional hearings on the Senate side, the head of the New York State Society of Certified Public Accountants – who was also the head of Haskin and Sells – now Deloitte Touche – went down to Washington and testified and convinced the guys to let the CPA firms to do the auditing. The legislation was revised and hence the external auditing function that we have today".

18.10. No doubt there would be considerable opposition to the above proposal as auditing firms would not wish to lose their niches, but the present auditing arrangements have too many deficiencies and cannot form the basis of any effective system for regulation of banks. Some of deficiencies are as follows:

- The present auditing model does not reflect the current realities. For example, following the Companies Act and other laws, the audit report is addressed to shareholders. This is not appropriate. Firstly, shareholders are not the owners of banks. The average share holding periods for US and UK banks' shares fell from around three years in 1998 to around three months by 2008[32]. Shareholders function more like traders and speculators and do not have a long-term interest in the welfare of banks. Secondly, shareholders do not provide most of the risk capital. For example, the 2011 annual accounts of Barclays bank show assets of £1.56 trillion and capital of only £65bn, i.e. gross leverage of 24 times. In other words, shareholder provides only about 4% of its capital and the remainder is provided by other stakeholders, including depositors and lenders. The 2011 annual accounts of Royal Bank of Scotland (RBS) show assets of £1.5trn against a capital of only £76bn i.e. a gross leverage ratio of nearly 20. So shareholders provide only about 5% of its capital. Other stakeholders have no rights in relation to auditors. The deposit protection scheme provided by the state spreads the risks on to taxpayers, but the auditors do not owe any 'duty of care' to taxpayers or citizens either. The present auditing model is based on a fiction of shareholder ownership and risks and is utterly inappropriate for the 21st century.

---

[31] Lynn Turner Says Unless Big Four Change, Bring on SEC as Public Auditor, Corporate Crime Reporter , February 14, 2007.
[32] Speech given by Andrew Haldane, Executive Director for Financial Stability at the Bank of England, on 24 October 2011 (http://www.bankofengland.co.uk/publications/Documents/speeches/2011/speech525.pdf).

- The present auditing model expects one set of business entrepreneurs (auditors) to invigilate another (company executives). Their success is measured by fees, profits and clientele rather than performing any service for the state or society. External auditing is out of line with the common sense approach in other sectors. There are audits in many walks of life. For example audits are conducted by immigration officers (e.g. checking passports, visas), health and safety officers, fire officers, hygiene inspectors, trading standards officers, etc. In all of these cases, the auditee neither directly hires nor directly pays the auditors. These auditors are respected and even feared. The entirely opposite happens has been happening at banks. Rather than effective watchdogs auditors have functioned as puppies and poodles.

- Auditing firms have been auditing the same bank for years and become too cosy with directors. PricewaterhouseCoopers (and its predecessor firms) have audited Barclays Bank since 1896. Indeed, the average audit tenure at FTSE100 companies (banks are part of that) is 48 years. Seemingly, no lessons have been learnt from the 1970s, 1980, 1990s and the current banking crash. Accounting firms oppose rotation of auditors by claiming that due to knowledge deficiencies audit failures may occur in the early years of audits. This claim is problematical. For example, accounting firms compete to win new clients. If their assertions are correct then they must have done poor audits for all of their new clients. Yet they have never acknowledged the delivery of poor audits.

- The auditing industry has been unable to reconcile its quest for higher fees with effective audits. This much has been evident not only from the current banking crash, but also from the audits of Barings, Johnson Matthey, Bank of Credit & Commerce International (BCCI) and the mid-1970s banking crash. It is fashionable for auditors to claim that the sale of consultancy services to audit clients somehow does not impair their independence. This defence of the niches shows no regard for long established evidence. Ever since the 1970s, authoritative investigations in frauds and corporate collapses have drawn attention to the silence of the auditors, their fee dependency and collusive relationship with corporate executive. A few examples will provide an indication.

A 1976 report of the Department of Trade and Industry (DTI) inspectors on the silence of auditors at Roadships Limited[33] stated that “"Independence is essential to enable auditors to retain that objectivity which enables their work to be relied upon by outsiders. It may be

[33] Department of Trade and Industry, (1976c). Roadships Limited, London, HMSO.

destroyed in many ways but significantly in three; firstly, by the auditors having a financial interest in the company; secondly, by the auditors being controlled in the broadest sense by the company; and thirdly, if the work which is being audited is in fact work which has been done previously by the auditors themselves acting as accountants ... We do not accept that there can be the requisite degree of watchfulness where a man is checking either his own figures or those of a colleague. ... for these reasons we do not believe that [the auditors] ever achieved the standard of independence necessary for a wholly objective audit."

A 1976 DTI inspectors' report on Hartley Baird[34] found that the company was having difficulties in repaying loans. But the financial problems were covered-up by manipulation of the accounts. The report stated that the auditors were ineffective because of their close connections with company directors and suggested rotation of auditors.

A report on the 1978 collapse of the Grays Building Society[35] noted the folly of allowing the same firm to audit a client for forty years and said that the auditors silence was due to cosiness with directors.
A 1979 report on Burnholme and Forder[36] said that "in our view the principle of the auditor first compiling and then reporting upon a profit forecast is not considered to be a good practice for it may impair their ability to view the forecast objectively and must endanger the degree of independence essential to this work".

The audit firm's strategy was summed up by memo from the senior partner advising audit staff[37] that "The first requirement is to continue to be at the beck and call of RM [Robert Maxwell], his sons and staff, appear when wanted and provide whatever is required" (DTI, 2001, p. 367). Robert Maxwell had a known dubious business reputation and was a fraudster.

In 2003, a [former] Ernst & Young partner was arrested on criminal charges for allegedly altering and destroying audit working papers and obstructing investigations relating to NextCard (SEC press release, 25 September 2003). He became one of the first cases to be tried under the Sarbanes-Oxley Act 2002. He pled guilty and admitted that "he knowingly altered, destroyed and falsified records with the intent to impede and obstruct an investigation by the Securities and Exchange

[34] Department of Trade, (1976d). Hartley Baird Limited, HMSO: London
[35] Registry of Friendly Societies, (1979). Grays Building Society (Cmnd 7557), London: HMSO.
[36] Department of Trade and Industry, (1979). Burnholme & Forder Limited, London, HMSO.
[37] UK Department of Trade and Industry, (2001). Mirror Group Newspapers plc (two volumes), London: The Stationery Office.

Commission (SEC) … by not informing the SEC of these alterations and deletions that he knowingly concealed and covered up an original version of the documents with the intent to impede, obstruct, and influence an investigation of the SEC (Department of Justice press release, 27 January 2005).

In September 2005, Japanese regulators arrested four partners of ChuoAoyama PricewaterhouseCoopers for allegedly helping executives at Kenebo, an audit client, to falsify company accounts. (Financial Times, 14 September 2005). The four were suspected of working with two Kanebo executives to produce false consolidated financial statements showing that Kanebo's assets exceeded its debts in fiscal year 2001 and 2002. In reality, its debts exceeded its assets by Y81.9bn and Y80.6bn, respectively. Subsequently, the regulator stated that "ChuoAoyama PricewaterhouseCoopers admitted the facts charged in the Kanebo accounting fraud scandal[i]" and that the four "willfully certified Kanebo's falsified annual reports for the five periods, ending March 1999, March 2000, March 2001, March 2002 and March 2003, as not containing such falsities".

18.11. Similar concerns about auditors being cosy with companies by selling consultancy services and through longevity in office have been raised by episodes, such as Enron, WorldCom, BCCI and others. Concerns about auditor independence have been raised by the collapse of Lehman Brothers where auditors allegedly advised the bank on creative accounting schemes.

18.12. The above is part of a larger amount of evidence which shows that accountancy firms priorities fees over everything else. They cannot form a reliable pillar in an effective system of banking regulation.

- Recent events relating to LIBOR manipulations at Barclays Bank and UBS suggest that auditors failed to adequately evaluate internal controls. The US regulators have drawn attention to hundreds of thousands of suspect money laundering transactions at HSBC and Standard Chartered Bank, but auditors seem not be aware of such failures. The silence of the auditors is price of close financial relationship between auditors and banks. Auditors receive audit fees, non-audit fees and insolvency work from banks. Accountancy firms also collaborate with banks to design and market tax avoidance schemes. The fee dependency affects the quality of judgements made

- The auditing industry and banks would say that audit committees act as buffers. However, the value of presently constituted audit committees must be doubted. The audit committees consist of non-executive directors who owe their position to patronage of executive directors and are rarely able or willing to make critical evaluation of directors' decisions. They are not elected by the stakeholders and thus cannot be called to account by the parties affected by their decisions. They collect large amounts of fees for relatively little time and are not in a position to invigilate auditors. Audit committees have been spectacularly unsuccessful at banks and hardly any made any public criticisms of the shortcomings of auditors or financial reports of banks.

- For any system of auditing to work there must be effective checks and balances. Yet auditing lacks that. Cases such as MAN Nutzfahrzeuge AG & Anor v Freightliner Ltd & Anor [2007] EWCA Civ 910) show that auditors can be negligent yet escape liability. It is difficult to see how such a regime can form the basis of effective regulation of banks.

- There is little effective professional discipline of accountants. No accountancy firm has ever been disciplined by any professional body for selling aggressive tax avoidance schemes. No action is taken even after the court/tribunals have declared a scheme to be unlawful.

- There is little effective action for audit failures. A recent example is about the Farepak debacle, which occurred in 2006. On 15 November 2012, the FRC announced that it is to examine the alleged audit failures by Ernst & Young in 2005. This is part of a long list of do little approach/

- There are no independent standards for auditors. In principle the Financial Reporting Council (FRC), but it is too close to accounting firms. It has acted more as a cheerleader rather than an effective regulator for the industry. It is hard to find any standards on the public accountability of auditing firms who enjoy the state guaranteed market of external auditing. What fees and profits do accounting firms make from tax avoidance? What is the composition of audit teams? The FRC has failed to examine the internal culture of auditing firms even though evidence suggests that significant part of work is falsified.

- Despite the recommendations contained in the House of Commons Treasury Committee's report on Northern Rock, it has failed to ban the sale of non-auditing services by auditors to their audit clients, or cap the tenure of auditing firms. Its cosiness with the auditing industry, or is it blindness, is apparent from the rules for non-executive directors. In folklore non-executive directors must have a degree of independence even though they are not required to give an opinion on financial statements. The UK Combined Code on corporate governance (issued by the Financial Reporting Council), which gives no enforceable rights to any stakeholder or regulator, requires that non-execs must not have been an employee of the company in the last 5 years, must not receive income other than director fees and most not serve as a Non-Executive Director for more than 9 years with the same company. However, the equivalent rules do not apply to auditors. There are no limits on the auditor's tenure and they are not required to act exclusively as auditors.

18.13. This section has provided only part of the evidence to argue that the present auditing model has failed. Auditors have not been the eyes and ears of regulators and cannot serve the public interest. This model should be replaced and the state itself has to take responsibility for directly auditing banks.

19. **What would be the effect of using return on assets as a performance measure in banks, as opposed to return on equity?**

19.1. The return on equity is influenced by leverage and accounting games played by directors. Return on equity may have some significance if shareholders were the owners of companies or the main providers of capitals. Neither of these propositions is true as shareholders have only a short-term interest in companies and in most banks only provide around 5% of total capital. Some may wish to use market prices of equity to measure performance, but markets are not necessarily rational. In the words of Lord Adair Turner, former Chairman of the Financial Services Authority, "the collective market view was that risks to bank credit-worthiness had fallen steadily between 2002 and 2007, reaching a historical low in the early summer of 2007, the very eve of the worst financial crisis for 70 years. Neither CDS spreads nor bank equity prices provided any forewarning of impending disaster: instead they validated and strongly reinforced a surge of over-exuberant and under-priced credit extension to the real economy[38]".

19.2. All accounting related measurements are malleable and can easily be manipulated and thus should not be the sole basis for assessment of performance. The classification of assets in balance sheets depends on whatever the politics of accounting permit. Today companies may include intellectual property on their balance sheet, but not so long ago this was not the case. Banks show goodwill (difference between the purchase price of an entity and the fair value of net tangible assets) on their balance sheet on the assumption that this will enable them to earn superior profits. At times of economic recessions, such assumptions are unreasonable. Even at other times such assumptions are

[38] Lord Tuner, Market Efficiency and Rationality: Why Financial Markets are Different, London School of Economics Lecture, 12 October 2010 (http://www2.lse.ac.uk/assets/richmedia/channels/publicLecturesAndEvents/transcripts/20101012_1830_marketEfficiencyAndRationality_tr.pdf).

problematical because no one can measure the so-called superior profits. It may also be argued that goodwill is the outcome of a book-keeping quirk rather than a representation of any economic substance. Nevertheless, bank balance sheets have shown this as an asset. Even the profit side is problematical because banks, and other corporations, do not recognise the full social cost of their operations. Bank accounts only recognise private costs and even these are subject to accounting games. Management have plenty of discretion on accruals and shuffling of costs. For example, depreciation is an integral part of accounts, but the charge to the profit and loss accounts depends on assumptions about the future life of the assets, impairment and residual values. Corporate profits can also be increased through curtailment of research and development, lack of investment, wage freezes, dilution of employee pension rights and tax avoidance, all of which have serious consequences for the long-term welfare of organisations.

19.3. Non-financial measures should also be used to complement any measure of performance. These include mattes such as investment, job creation, providing finance to emerging businesses, staff training, staff retention, staff welfare, maintaining branch networks, customer satisfaction and freedom from regulatory action. Such variables require bank directors to think about the long-term rather than just the short-term.

20. **Are the amendments to the Financial Services and Markets Act 2000 regarding dialogue between regulator and auditor sufficient, or does further work need to be done in this area?**

20.1. Reliance on accounting firms to invigilate banks is unlikely to be productive. It has not yielded positive results. The firms have a history of failures and are mired in conflict of interests.

20.2. An alternative institutional structure (briefly sketched above) is likely to be more effective and will to provide regulators with real-time information

APPENDIX 1
Audit Report OF Major Banks just before the Banking Crash

Company	Country	Year End	Auditor	Date of Audit Report	Audit Opinion	Fee (Millions) Audit	Non-Aud
Abbey National	UK	31 Dec 2007	D&T	4 Mar 2008	Unqualified	£2.8	£2.1
Alliance & Leicester	UK	31 Dec 2007	D&T	19 Feb 2008	Unqualified	£0.8	£0.8
Barclays	UK	31 Dec 2007	PwC	7 Mar 2008	Unqualified	£29	£15
Bear Stearns	USA	30 Nov 2007	D&T	28 Jan 2008	Unqualified	$23.4	$4.9
Bradford & Bingley	UK	31 Dec 2007	KPMG	12 Feb 2008	Unqualified	£0.6	£0.8
Carlyle Capital Corporation	Guernsey	31 Dec 2007	PwC	27 Feb 2008	Unqualified	N/A	N/A
Citigroup	USA	31 Dec 2007	KPMG	22 Feb 2008	*Unqualified	$81.7	$6.4
Dexia	France/ Belgium	31 Dec 2007	PwC + Mazars & Guérard	28 Mar 2008	Unqualified	€10.12	€1.48
Fannie Mae	USA	31 Dec 2007	D&T	26 Feb 2008	Unqualified	$49.3	---
Fortis	Holland	31 Dec 2007	KPMG/PwC	6 Mar 2008	Unqualified	€20	€17

Freddie Mac	USA	31 Dec 2007	PwC	27 Feb 2008	*Unqualified	$73.4	---
Glitnir	Iceland	31 Dec 2007	PwC	31 Jan 2008	Unqualified	ISK146	ISK218
HBOS	UK	31 Dec 2007	KPMG	26 Feb 2008	Unqualified	£9.0	£2.4
Hypo Real Estate	Germany	31 Dec 2007	KPMG	25 Mar 2008	Unqualified	€5.4	€5.7
Indymac	USA	31 Dec 2007	E&Y	28 Feb 2008	*Unqualified	$5.7	$0.5
ING	Holland	31 Dec 2007	E&Y	17 Mar 2008	Unqualified	€68	€7
Kaupthing Bank	Iceland	31 Dec 2007	KPMG	30 Jan 2008	Unqualified	ISK421	ISK74
Landsbanki	Iceland	31 Dec 2007	PwC	28 Jan 2008	Unqualified	ISK259	ISK46
Lehman Brothers	USA	30 Nov 2007	E&Y	28 Jan 2008	Unqualified	$27.8	$3.5
Lloyds TSB	UK	31 Dec 2007	PwC	21 Feb 2008	Unqualified	£13.1	£1.5
Northern Rock	UK	31 Dec 2006	PwC	27 Feb 2007	Unqualified	£1.3	£0.7
Royal Bank of Scotland	UK	31 Dec 2007	D&T	27 Feb 2008	Unqualified	£17	£14.4
TCF Financial Corp	USA	31 Dec 2007	KPMG	14 Feb 2008	Unqualified	$0.97	$0.05

Thornburg Mortgage	USA	31 Dec 2007	KPMG	27 Feb 2008	Unqualified	$2.1	$0.4
UBS	Switzerland	31 Dec 2007	E&Y	6 Mar 2008	Unqualified	CHF61.7	CHF13.4
U.S. Bancorp	USA	31 Dec 2007	E&Y	20 Feb 2008	Unqualified	$7.5	$9.6
Wachovia	USA	31 Dec 2007	KPMG	25 Feb 2008	Unqualified	$29.2	$4.1
Washington Mutual	USA	31 Dec 2007	D&T	28 Feb 2008	Unqualified	$10.7	$4.3

Notes: 1) Data as per financial statements and statutory filings shown on the respective company's website.
2) 'Audit fee' also includes 'audit related fees'
3) * Denotes that audit report draws attention to some matters already contained in the notes to financial statements

[i] http://www.fsa.go.jp/en/conference/minister/2006/20060331.html

21 December 2012

Written evidence submitted by Professor Michael P. Devereux and Dr. John Vella

1. How, if at all, does the tax system encourage leverage in banks?

The UK corporate tax system, like that in most jurisdictions, favours debt over equity since the costs of debt, but not equity, are deductible for corporation tax.

1.1.1 How large is this effect?

A recent study by Keen and de Mooij examines this issue.[1] Using data for banks in 82 countries across Europe, Asia, and the Americas, the authors estimate that the long run effect of, say, a 10 percentage point increase in the corporate tax rate would be to increase the leverage ratio, in the short run by 1.8 percentage points, and in the long run by 2.8 percentage points. This is similar to estimates that have been made in other studies for non-financial firms.[2]

The authors point out, however, that there are important differences across banks. For example, "the largest 5 percent of banks — holding almost 60 percent of all bank assets — are considerably less responsive to taxation…" This is an important point to keep in mind given the size and concentrated nature of the UK banking sector.[3]

1.1.2 What are the determinants of the size of the effect?

As banks are subject to minimum capital requirements, they might be thought to be less sensitive to tax in their financing decisions. However, banks are known to hold a buffer of equity above these requirements, leaving some scope for tax to affect their financing decisions. Furthermore, the nature of banks' business and the availability of hybrid instruments might allow banks to exploit the asymmetric tax treatment of debt and equity more than other companies.[4]

Of course, the tax preference of debt over equity is just one of a number of factors which influences any company's financing decisions. In addition to the factors which influence all companies, the deposit guarantee scheme and the implicit bailout guarantee for banks constitute further incentives for banks to hold debt over equity.

1.1.3 Do taxes other than the corporate system introduce any distortion?

Corporation tax is the most relevant tax for distorting financing choices in the UK financial sector. Of course, the Bank Levy is a tax broadly levied on the debt of the bank, and hence should be expected to have an effect in the opposite direction.

1.1.4 To what extent is the distortion offset by the personal tax system?

---

[1] Michael Keen and Ruud de Mooj, "Debt, Taxes and Banks", IMF Working Paper 12/48 (2012).
[2] Ruud de Mooij, "The Tax Elasticity of Corporate Debt: A Synthesis of Size and Variations", IMF Working Paper 11/95 (2011).
[3] See Independent Commission on Banking, "Final Report, Recommendations ", (September 2011), pp. 166-171.
[4] Michael Keen and Ruud de Mooj, "Debt, Taxes and Banks", IMF Working Paper 12/48 (2012), p.4.

It seems unlikely that the corporation tax advantage to debt finance is substantially offset by the personal tax system. This could in principle be the case if there was asymmetry in the personal tax system, with interest received being taxed, and the return to equity finance being untaxed. But both forms of return are taxed in numerous ways depending on the identity of the provider of funds.

1.1.5 Would regulatory constraints on capital no longer bind if the distortion were removed?

Empirical evidence does not suggest that the tax advantage to debt is the main driver in determining the leverage of the UK financial sector. This is more likely to be due to the combination of limited liability and explicit or implicit support for lenders in the event of potential default. So it is likely that regulatory constraints would still be important even if the tax advantage to debt were removed.

1.1.6 Has the responsiveness of the effect to its determinants changed over time?

There is some evidence that the response of non-financial firms to the tax advantage of debt has been increasing over time.[5] However, we are not aware of evidence relating specifically to the financial sector.

1.2 What is the best way of removing any such bias?

Broadly at present, all interest payments are deductible from tax, but no allowance is given for the cost of equity finance. A symmetric position could be achieved by giving full relief for the cost of equity finance, removing the tax deductibility of interest, or giving partial relief for both forms of finance. At an unchanged interest rate, the first would result in a revenue cost and the second in a revenue gain. The third option could be revenue-neutral if an appropriate amount of partial relief were allowed.

1.2.1 ACE vs CBIT

The Allowance for Corporate Equity (ACE) was first proposed by the IFS Capital Taxes Group in 1991.[6] The basic approach would allow a deduction from corporation taxable profit for a measure of the cost of equity finance. This would be based on a value of the equity invested in the firm, multiplied by a specific rate of return. The value of equity would include new issues, and retained earnings (measured as taxable profit less dividends). The appropriate rate of return would depend on whether the government guaranteed to offer the ACE allowance in all circumstances; if so, then the appropriate rate of return would be the risk free rate.

The Comprehensive Business Income Tax (CBIT) was first considered in detail in a study by the US Treasury in 1992.[7] Broadly, this would disallow deductions for

---

[5] Ruud de Mooij, “The Tax Elasticity of Corporate Debt: A Synthesis of Size and Variations”, IMF Working Paper 11/95 (2011).

[6] IFS Capital Taxes Group, “Equity for Companies: a corporation tax for the 1990s”, London: Institute for Fiscal Studies.

[7] Treasury Department, “Integration of the Individual and Corporate Tax Systems: Taxing Business Once”, Washington DC, Bureau of National Affairs, 1992.

interest payments from the tax base. The tax would then fall on total income, with no deduction for the cost of finance.

The US Treasury believed that the system would work best with no further taxation on the receipt of either interest or dividends at the personal level. But in principle this would also apply to financial intermediaries. That is, if a UK bank receives interest from a loan to a UK company, then applying the CBIT generally would mean that the UK company would not receive relief for the interest that it pays to the bank. In this case, it would not be appropriate to tax the bank on the interest that it receives from the company. As far as the transaction between the bank and the company is concerned, it makes little difference whether the interest payment is taxed in the hands of the borrower or the bank, since the rate of interest should adjust. However, this approach raises a number of questions about the treatment of interest received from non-UK borrowers, and the treatment of other financial expenses, such as fees.

1.2.2 Are there any other workable options?

One proposal has been to allow the same proportion of the costs of debt and equity finance to be deductible from tax. In principle, the proportion could be chosen in such as way as to be revenue-neutral for a given tax rate. However, there have been no studies examining the practicalities of such a reform.

More generally, the distinction between debt and equity in tax law gives rise to considerable complexity, as well as scope for tax planning, due to the difficulty of identifying the appropriate category for different financial instruments. As far as possible, this distinction should not be made. Introducing an ACE would still leave technical differences in the treatment of debt and equity. An alternative would be simply to allow a notional deduction for the cost of all finance – both debt and equity - to replace the deductibility of interest.

1.3 Can and should the reform be restricted to banks, as opposed to other financial and non-financial companies?

Either the ACE or CBIT could in principle be limited to banks, although the rationale for doing so is not clear. In this case, a non-financial company borrowing from a bank would still receive a deduction of interest, and so the interest could still be taxed in the hands of the lending bank. However, different rules would need to apply to inter-bank lending.

1.4 What are the administrative and international complexities involved in such a reform?

Introducing either an ACE or a CBIT would introduce new complexities. For example, introducing an ACE would clearly require the details of the construction of the allowance to be specified, whilst introducing a CBIT would require careful consideration of the circumstances in which interest received by banks would be taxed. However, by eliminating, or at least reducing, the importance of the distinction between debt and equity, the introduction of either the ACE or the CBIT may also help to reduce some existing complexities.

1.4.1 What would happen if the UK unilaterally introduced an ACE reform?

Ceteris paribus, the UK would become a more attractive location for firms if an ACE were introduced, primarily because the amount of tax due in the UK would be lower than at present. However, given that banks use so little equity, the reduction in tax liabilities from introducing an ACE would be small. In any case, such an effect could be achieved in other ways, such a simply lowering the tax rate. To the extent that an ACE was introduced in a revenue-neutral way, by raising the corporation tax rate, then on average the benefit of locating in the UK would not change. But companies with relatively low rates of profit would benefit from the higher allowance, while companies with relatively high rates of profit would lose more from the higher tax rate.

1.4.2 Are there any international legal obligations preventing a reform in the UK?

After reviewing this issue, the Mirrlees Review concluded that the introduction of an ACE is feasible in the UK, and also that it is "capable of implementation in a manner that is compatible with EU law."[8] The recent implementation of a similar reform in Belgium was used in support of this conclusion.

1.4.3 How should the balance sheet of UK banks' foreign subsidiaries, and intra-group debt and equity positions, be treated for the purposes of the reform?

The basic ACE proposal is for a tax on income generated in the UK. The ACE allowance would be based on *net* equity; that is equity raised in the UK less any equity invested in foreign subsidiaries. This would limit the value of the ACE allowance to equity that was used to finance activities taking place in, and taxed in, the UK. There would be no change to the treatment of debt finance.

UK companies can elect for UK tax exemption on profits and losses of trading activity carried out overseas through a branch. If this election is made, some difficulties arise since branches do not have easily observable levels of debt and equity. As a result it would be difficult to determine the ACE allowance that should apply to activities remaining in, and taxed in, the UK.

1.5 What are the implications of a reform for the Bank Levy?

As noted above, there are non-tax incentives for banks to favour debt over equity. If the tax distortion in favour of debt is removed through an ACE, an argument can still be made for the Bank Levy to counter these non-tax incentives in favour of debt.

1.6 How much would the reform cost?

The revenue cost of introducing an ACE for all companies, and holding the corporation tax rate unchanged, has been estimated at around 0.3 percentage points of

[8] Institute of Fiscal Studies and James Mirrlees (eds), 'Tax by Design', Oxford University Press, (September 2011), p. 449.

GDP.[9] However, limiting the introduction of an ACE to banks should cost considerably less given that this is only one sector of the economy, and that banks typically use only a very small amount of equity.

1.6.2 Is it practical to apply the allowance only to new equity?

In principle, in introducing an ACE there is a good case for restricting the relief to new equity; in the incentive to use new equity rather than new debt is immediate, but the cost to the Exchequer would be much lower than if it were applied to all equity. However, such a rule may well give rise to tax planning aimed at transforming old equity into new equity, possibly by creating new companies.

1.6.3. Can the rate be increased to offset the narrower base?

If an ACE were introduced, the corporation tax rate could be raised to offset the narrowing of the tax base (and this could be done only for companies that could use an ACE). However, this is problematic. A higher statutory tax rate would create a greater incentive to shift remaining taxable income to jurisdictions with a lower tax rate. Of course, if the cost of the reform were relatively modest, the required increase in the tax rate would also be modest.

1.7 What are the economic consequences of financial services not being subject to VAT?

Imposing VAT on financial services is difficult because of the need to define the price for margin-based operations (e.g. taking deposits and granting loans). As a result, most financial services are exempt from VAT under the regime followed in the EU. This is problematic for a number of reasons.

a. Under-taxation

One problem is that the exemption of financial services might lead to the under-taxation of the industry, thus allowing the sector to become larger than it otherwise would be. However, whether the exemption actually leads to the under-taxation of the industry is unclear. Exemption means that banks do not charge their customers VAT, but it also means that they cannot recover VAT on costs they incur. Overall, it is thought that the VAT exemption increases the tax burden on transactions with businesses (as banks will pass on the cost of not being able to recover input VAT) and reduces the tax burden on services to consumers (as consumers would normally be subject to VAT).

---

[9] Ruud A. de Mooij and Michael P. Devereux "An applied analysis of ACE and CBIT reforms in the EU", *International Tax and Public Finance*, February 2011, Volume 18, Issue 1, pp 93-120,

Establishing empirically whether overall the VAT exemption leads to under-taxation is difficult. Some studies have found that it does – including a recent study by the EU Commission.[10] But another recent study found that the VAT exemption leads to neither over-taxation nor under-taxation.[11] At this point in time it is fair to say that this empirical question is still open.

b. Further problems

Further problems arise as a result of VAT exemption and hence banks' inability to reclaim VAT paid on inputs. Some of these problems were listed in the Mirrlees Review:

- "overpricing of financial services provided to other businesses, which ought not to bear any tax;
- a bias towards sourcing financial services (and anything produced using them) from countries that have lower VAT rates or that have a narrower (i.e. more generous) interpretation of what are non-creditable inputs;
- difficulty identifying which inputs are attributable to exempt activities, where firms undertake a combination of taxable and exempt activities (as financial institutions typically do);
- a bias towards minimizing the use of taxed inputs—specifically, towards the use of zero-rated inputs and towards vertical integration as banks do as much as possible in-house (provide their own cleaning and security services, for example) to avoid paying VAT on purchased inputs."[12]

1.8 Should financial transactions or 'financial activity' be taxed?

In the aftermath of the recent financial crisis a tax on transactions was proposed by the European Commission (Financial Transactions Tax – FTT),[13] whilst a tax on financial activities was proposed by the IMF (Financial Activities Tax – FAT).[14] The FAT is a tax on the profits and remuneration of financial institutions. The purpose of the FAT proposed by the IMF is primarily revenue-raising, and thus contributing to the wider fiscal costs of the crisis, however the FAT could achieve other objectives depending on the way it is designed. The IMF considered three versions of a FAT.

[10] European Commission, *Impact Assessment, accompanying the document 'Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC, Vol. 1'*, SEC(2011) 1103 final, (September 28, 2011) pp. 13-15.

[11] Ben Lockwood, "Estimates from National Accounts Data of the Revenue Effect of Imposing VAT on Currently Exempt Sales of Financial Services Companies in the EU", (October 2011). This report was published as an appendix to the study: PwC, "How the EU VAT exemptions impact the Banking Sector" (October 2011).

[12] The Mirrlees Review was a broad review of the tax system undertaken by a group of leading tax academics/experts and led by Nobel Laureate Professor Sir James Mirrlees. Institute of Fiscal Studies and James Mirrlees (eds), 'Tax by Design', Oxford University Press, (September 2011), pp. 196-197.

[13] European Commission, *Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC Brussels*, COM(2011) 594 final, (September 2011). For a critical analysis of this proposal see John Vella, Clemens Fuest and Tim Schmidt-Eisenlohr, 'The EU Commission's Proposal for a Financial Transaction Tax' (2011) *British Tax Review*, 607. Taxes on financial transactions have been proposed for some time.

[14] IMF, *A fair and substantial contribution by the financial sector – Final Report for the G-20*, (June 2010).

FAT 1 is a broad tax on wages and profit, akin to a tax on value added. FAT 2 adopts a narrower definition, including only returns to capital and labour above the minimum their providers require. And FAT 3 is narrower still, applying only to very high rates of return.

Whether either tax should be introduced depends on the objectives being pursued.

- Raise revenue:

  If the objective is simply to raise further revenue from the financial sector, a tax on transactions appears to be the less attractive option of the two. A tax on transactions appears to be more distortive, more susceptible to avoidance through relocation and more likely to be passed on to consumers than certain forms of taxes on financial activities.[15]

- Compensate for VAT exemption:

  As noted in the answer to question 1.7 there is some uncertainty surrounding the effect of the VAT exemption. If, however, it is considered necessary to compensate for the VAT exemption by introducing a further tax on the financial sector, a tax on financial activities would be a better option than a taxe on transactions. Indeed FAT 1 can be seen as a substitute for VAT as its tax base includes wages plus profits. An even better solution would be to fix the VAT system itself.

- Reduce certain forms of trading:

  A tax on transactions might be considered to reduce short-term trading, particularly high-frequency trading. This is one of the objectives of the FTT proposed by the European Commission. However, as the Commission itself recognised, the evidence on the effect of these forms of trading is still inconclusive. Furthermore, studies suggest that a tax on financial transactions might have negative consequences including reduced liquidity and increased volatility as well as reduced asset prices and increased cost of capital.[16] The issues raised by these forms of trading are better addressed through regulation.

- Economic rents:

  FAT 2 is a tax on supernormal wages and profits in the financial sector and thus could be a means of taxing economic rents in the sector.

- Discourage risk taking:

[15] As the Mirrlees Review pointed out taxes on transactions are unattractive from an economic point of view. Institute of Fiscal Studies and James Mirrlees (eds), 'Tax by Design', Oxford University Press, (September 2011), pp. 151-153.

[16] A brief summary of these issues can be found in Government Office for Science, 'The Future of Computer Trading in Financial Markets: An International Perspective - Final Project Report' (2012), pp. 127-128.

FAT 3 is a tax on "very" high wages and profits and thus could be a means to discourage risk taking.

1.9 What are your views on suggestions that there should be an additional bank levy to bail out future failures?

A bank levy imposed with the express purpose of raising revenue for future bail-outs has the negative effect of making explicit the implicit bail-out guarantee enjoyed by some banks[17] and increases moral hazard. On the other hand, whilst measures are being adopted to reduce the need for future bail-outs it is unlikely that this can ever be eliminated. Therefore, some banks continue to enjoy an implicit bail-out guarantee which leads to cheaper debt finance and hence higher profits. As banks do not pay for this guarantee, one could argue that there is a case for a levy on these grounds, although it would be advisable not to expressly link it to future bail-outs.

A bank levy was proposed by the IMF in the aftermath of the crisis and has since been adopted in a number of countries. The IMF noted that the levy should be linked to a special resolution regime for banks to avoid the perception that the receipts would be used to support failing institutions.[18] When adopting the UK bank levy, HM Treasury was clear in stating that the revenue was not to be used to fund bank bail-outs, or, indeed, the special resolution regime for banks. Instead, one of the levy's objective was said to be "to ensure that banks make a contribution that reflects the potential risk to the UK financial system and wider economy from bank failures and consequent loss of consumer and investor confidence."[19]

In this context it is also worth pointing out that bank levies following the IMF model, including the UK bank levy, have a second objective, namely that of encouraging banks to move to less risky sources of funding. The UK bank levy, for example, provides incentives for banks to hold more equity, long-term liabilities and highly liquid assets. However, the current UK bank levy only goes a small way in countering the corporation tax incentive in favour of debt.

2. Do banks' attitudes to tax planning affect banking standards and culture, and does this have any effect on the wider economy?

Aggressive tax planning and tax avoidance are certainly not unique to the banking sector. However, anecdotal evidence suggests that certain banks are, or at least were, known to be particularly aggressive. Furthermore, apart from using aggressive planning/avoidance to reduce their own tax bills or those of their employees, banks also facilitate aggressive planning/avoidance by others.[20]

---

[17] See for example, Joseph Noss and Rhiannon Sowerbutts, "The implicit subsidy of banks", Bank of England, Financial Stability Paper No. 15 – May 2012.

[18] IMF, "A fair and substantial contribution by the financial sector" Final Report for the G-20, (June 2010).

[19] HM Treasury, "Bank Levy: a consultation", (July 2010), para. 1.8.

[20] The OECD has given particular attention to tax planning by banks, and the broader role banks play in the tax planning of others. See OECD, "Study into the Role of Intermediaries" (2008); OECD, "Report on Building Transparent Tax Compliance by Banks" (2009); and OECD, "Framework for a Voluntary Code of Conduct for Banks and Revenue Bodies" (2010).

HM Revenue and Customs have thus explained:

> "Banks have historically promoted tax avoidance on their own account, for clients and for their staff. Their behaviour has been more aggressive than that of other sectors. At a time when banks have received more Government help than other industries, the public expects banks to show a high degree of responsibility and the highest standards of corporate governance. But these standards are no different from those that it is expected other large corporate taxpayers should adopt."[21]

Tax avoidance gives rise to a number of issues which affect the wider economy. Tax avoidance leads to a reduction in revenue collected; creates a sense of unfairness amongst taxpayers which might lead to a reduction in overall compliance; entails the utilisation of time and resources which could be diverted to more productive ends; and contributes to an increasingly complex tax regime which in turn reduces the attractiveness of the UK as a place to locate or invest.

One could speculate about whether a bank's aggressive attitude to its tax affairs, and its willingness to 'game' tax legislation, influences the bank's broader standards and culture, including its attitude towards other forms of regulation. However, causality here is not obvious and this thus remains a matter of speculation.

5. What are your views on the effectiveness of the Code of Practice on Taxation for banks? Would the Code benefit from having sanctions and if so what should these be?

In 2009 the then Chancellor of the Exchequer, Alistair Darling, announced the introduction of a Code of Practice on Taxation for Banks (the "Code").[22] The Code is said to be voluntary, although the current Chancellor of the Exchequer, George Osborne, gave the major UK banks a deadline within which to sign up to it.[23]

The most controversial aspect of the Code relates to banks' tax planning. The Code explains that "[t]he Government expects that banking groups, their subsidiaries, and their branches operating in the UK, will comply with the spirit, as well as the letter, of tax law, discerning and following the intentions of Parliament." The principles introduced by the Code thus include: "banks should…not undertake tax planning that aims to achieve a tax result that is contrary to the intentions of Parliament." The Code's expectations on tax planning refer to banks' own tax planning, tax planning involved in the remuneration of their employees and tax planning promoted by banks to third parties.

---

[21] HMRC, "A Code of Practice on Taxation for Banks - Consultation Response Document", 9 December, 2009, p.8.

[22] See <http://www.guardian.co.uk/business/2009/jun/26/banks-tax-avoidance-darling-hitlist>; <http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageImport_ShowContent&propertyType=document&columns=1&id=HMCE_PROD1_030008>.

[23] <http://www.hm-treasury.gov.uk/press_66_10.htm>

This principle raises a number of questions. Taxpayers are entitled to arrange their affairs in any manner they deem fit as long as it complies with the law. Whether a particular arrangement complies with the law is ultimately a matter for courts to decide. In reaching their decision, courts follow a purposive interpretation of statutes, meaning that they do not merely follow the letter of the law, but they also look at the context of the particular provision in terms of the purpose of the statute as a whole.

The Code, as seen, enjoins banks to look beyond the letter of the law to the spirit of the law and thus not to enter into transactions that are contrary to the intention of Parliament. HMRC explain what they mean by intention of Parliament in this context:

> "In arriving at a view as to whether the transaction is contrary to the intentions of Parliament, the bank should *not only consider a purposive construction* of the legislation but should also consider whether Parliament can realistically have intended to give the proposed result in circumstances that are very different from those that existed at the time (e.g. are loopholes being used to arrive at an unexpected result). The question of whether the tax results are contrary to the intentions of Parliament can be answered in practice by asking whether the tax consequences of a proposed transaction are too good to be true. The Government has a track record of acting to close avoidance opportunities of which it becomes aware." [24]

> "…we will suggest banks answer the question of whether the transaction is contrary to the "intentions of Parliament" in practice by asking whether the tax consequences of a proposed transaction are too good to be true, so that the tax consequences would be a surprise to HMRC. This is because a tax result contrary to the "intentions of Parliament" would not be what HMRC would expect."[25]

By requiring banks to go beyond a purposive interpretation of statute, the Code essentially requires banks to go beyond the demands of the law and refrain from a transaction even if a court would deem it to be compliant with the law. In other words, it requires banks to arrange their affairs in line with the law as interpreted by HMRC or as HMRC would like it to be.

That the Code expects banks to refrain from transactions that comply with the law can be seen in as much as a recent HMRC document refers to the Code's "overall intent of constraining destabilising tax avoidance transactions *that are likely to trigger a need for Parliament to consider legislative change*."[26] If there is a need to change the law, it is because the law is considered to be inapt to deal with the avoidance scheme, which pre-supposes that the avoidance scheme itself is within the law.

[24] HMRC, *A Code of Practice on Taxation for banks - Supplementary Guidance Note*, 9 December 2009, pp. 4-5 (emphasis added).

[25] HMRC, *A Code of Practice on Taxation for banks – Consultation Response Document*, 9 December 2009, p. 9.

[26] HMRC, *HMRC Governance Protocol on compliance with the Code of Practice on Taxation for Banks*, 26 March 2012, p.6 (emphasis added).

Of course, a bank which signs up to the Code can always decide to pursue a transaction on the basis of an interpretation of the law with which HMRC disagrees. If challenged the ultimate decision will be taken by a court. However, this might lead to the bank being deemed to be in breach of the Code by HMRC. Currently, the consequences of being in breach of the Code include not being considered low risk, which entails, amongst other things, greater scrutiny of its tax affairs.[27] HMRC expect the bank to acknowledge the fact that it has been deemed to be in breach of the Code in any public pronouncements it makes on its operation of the code.[28]

This approach raises a number of constitutional questions. In our view, introducing sanctions against banks which breach the Code is not appropriate. The Financial Markets Law Committee, chaired by Lord Hoffmann, had the following to say on the use of the "intention of Parliament" and the imposition of sanctions in the first draft of the Code:

> "It does not appear to this Committee that there are any other circumstances in which it would be considered legitimate for an agency of the executive to require citizens to comply, not just with the law as it exists, but with the law as the executive would like it to be and to police this requirement with potentially stringent sanctions. While it is recognised that tax planning and tax avoidance are currently emotive political issues, it does not appear to the FMLC that these are sufficient grounds to justify such a significant departure from well-established "rule of law" values such as: a) the law must be clear and ascertainable so that citizens can govern their conduct according to its precepts; and b) citizens are entitled to expect that administrative decisions will be applied to them on the same basis."[29]

In February 2012, HM Treasury intervened in a high-profile avoidance case involving Barclays. The Treasury took the uncommon step of introducing retrospective legislation[30] to ensure that the transactions in question would not work. This step was partly justified on the ground that Barclays had signed up to the Code.[31] Presumably, if retrospective legislation was required to ensure that the schemes did not work, the view was taken that, at the very least, they might have worked under existing legislation.

Questions arise if the Code is seen as giving a carte blanche for retrospective legislation whenever banks which signed up to the Code enter into tax planning which

---

[27] HMRC, *A Code of Practice on Taxation for banks - Supplementary Guidance Note*, 9 December 2009, p.9.

[28] HMRC, *HMRC Governance Protocol on compliance with the Code of Practice on Taxation for Banks*, 26 March 2012, p.4.

[29] Financial Markets Law Committee, *Response to the June 2009 HM Revenue & Customs Consultation Document on a Code of Practice for Banks*, Issue 146, October 2009, para. 5.10.

[30] On the issues which arise in the use of retrospective tax legislation see, for example, Geoffrey T. Loomer, "Taxing out of time: parliamentary supremacy and retroactive tax legislation", *B.T.R.* 2006, 1, 64-90. See also, Treasury Select Committee, "Thirtieth Report – Budget 2012", 18 April 2012, paras. 85-89,

[31] See <http://www.guardian.co.uk/business/2012/feb/28/treasury-closes-barclays-tax-schemes>; <http://www.hm-treasury.gov.uk/d/wms_xst_270212.pdf>and <http://www.bbc.co.uk/news/business-17181213>

is contrary to HMRC's interpretation of the law or to what HMRC would like the law to be.

8 January 2013

Written evidence submitted by David Cairns OBE, MSc, FCA

Executive Summary

The role of the IASB and the UK's Financial Reporting Council (FRC) is to develop accounting standards that result in financial statements that present fairly (or show a true and fair view of) the reporting entity's financial performance at the balance sheet date and its performance for the period ending on that date. (Paragraphs 4 to 7)

The IASB and the FRC should not write accounting standards which seek to favour or protect particular entities or other interested parties. Decisions about such matters are the province of democratically elected governments and agencies appointed by such governments. (Paragraph 7)

Both IFRS and UK GAAP require the use of an incurred loss model for the measurement of the impairment of a bank's loans and advances. This model requires the bank to estimate the expected future cash flows from loans and advances based on the facts and circumstances at the balance sheet date. IFRS are more prudent than UK GAAP because IFRS require the expected future cash flows to be discounted to their present values at the balance sheet date. (Paragraphs 8 to 12)

Most UK banks made only small adjustments to their provisions for loan losses when making the transition from UK GAAP to IFRS. (Paragraph 11 and Appendix 1)

There is little evidence to support the assertion that accounting standards, including the use of fair value accounting, caused or played a major part in the financial crisis. (Paragraph 13)

The IFRS requirement for "fair presentation" is identical to the UK requirement for "a true and fair view" both in theory and practice. (Paragraphs 14 to 20)

The use of hidden or secret reserves to smooth profits does not result in "fair presentation" or a "true and fair view". (Paragraph 20)

The use of the IASB's proposed "expected loss model" would not have shifted significant amounts of losses from 2008 to 2007. (Paragraphs 11 to 26)

The additional amounts of provisions or reserves required by banking regulators should be recognised in the financial statements. The amounts should be presented prominently. They should also be presented separately from IFRS profit and IFRS equity and liabilities. (Paragraph 27)

The only "true and fair" method of accounting for trading instruments is fair value accounting. The use of the cost method is open to abuse and, in practice, tends to delay the recognition of losses. (Paragraphs 28 to 30)

Accounting standards should be developed for transactions and other events. They should not be developed for industries or sectors. (Paragraph 32)

Introduction

1. This evidence is based on my extensive experience over the last 30 years of accounting standards, in particular International Financial Reporting Standards[1]. From 1985 to 1994, I was the secretary-general of the IASB's predecessor body, the International Accounting Standards Committee (IASC). During this time the IASC developed IAS 30 *Disclosures in the Financial Statements of Banks and Similar Financial Institutions*[2] and began its work on financial instruments. In both projects, I involved representatives of the Bank of England and the Basel Committee. During my time at the IASC, I also played a major part in the development and drafting of the IASC's conceptual framework, the *Framework for the Preparation and Presentation of Financial Statements*[3]*.*

2. After leaving the IASC, I have provided IFRS consultancy and training services to companies, audit firms, professional bodies and government agencies. I have carried out surveys of the IFRS accounting policies of EU listed companies and interviewed approximately 20 UK listed companies on their experiences of making the transition from UK GAAP to IFRS. I have served on the IASB's advisory group for SMEs, the UK's Financial Reporting Review Panel and the Financial Services and Other Specialised Industries committee of the UK's Accounting Council. I assisted the Institute of Chartered Accountants of Scotland on its "principles versus rules" project. I have held academic appointments at the London School of Economics and Political Science and the University of Edinburgh Business School, taught at other universities and participated in many academic conferences.

3. My evidence focuses on questions 10 to 14 of panel's call for evidence. I have prefaced that evidence with my views on two related issues:
   - the role of the IASB (and national standard setters) with respect to the possible effects of accounting standards; and
   - the similarities and differences between IFRS and UK GAAP on the impairment of financial assets accounted for under the cost model.

---

[1] Formerly known as International Accounting Standards (IAS).
[2] IAS 30 has been superseded by IFRS 7 *Financial Instruments: Disclosures* which applies to all entities rather that solely to banks and similar financial institutions.
[3] The IASB has partly developed a revised conceptual framework.

The role of the IASB and other standard setting bodies

4. The role of the IASB is to develop, in the public interest, a single set of high quality, understandable, enforceable and globally accepted financial reporting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help investors, other participants in the various capital markets of the world and other users of financial information make economic decisions[4]. Put another way, IFRS financial statements should present fairly (or show a true and fair view of) the reporting entity's financial position at the reporting date and its performance and cash flows for the period ending on that date. The IFRS financial statements of different entities should present like transactions and other events in a like way.

5. IFRS financial statements are a comparable and reliable reference point or milestone that seek to meet the common needs of users who wish to make decisions about the entity. Those decisions include, for example[5]:

   - deciding whether to buy, hold or sell an equity investment in that entity;
   - assessing the stewardship or accountability of management and, as result, deciding whether to retain and how to remunerate that management;
   - assessing the ability of the entity to pay employee benefits;
   - assessing the security for amounts lent to the entity;
   - measuring how much taxation the entity should pay;
   - measuring the distributable profits of the entity and determining its distributions to shareholders; and
   - regulating the activities of the entity.

6. The IFRS financial statements are not the only information that users use to make such decisions. Furthermore, users often adjust the amounts reported in the IFRS financial statements to meet their specific needs. For example, investors adjust IFRS profits for use in the models they use to estimate the value of the reporting entity. Tax authorities (such as the UK HMRC) require adjustments to IFRS profits so as to exclude non-taxable income and non-tax deductible expenditure. Banking and insurance regulators adjust IFRS amounts in order to decide whether a bank or insurance entity has sufficient capital. The reporting entity itself may have to adjust IFRS profits in order to calculate its distributable profits in accordance with company law. These adjustments are not included in the IFRS financial statements because the adjusted measures are designed to meet the specific needs rather

[4] *IFRS Foundation Constitution*, para 2(a) and *Preface to International Financial Reporting Standards*, para 6(a).
[5] This list is derived from the preface to the IASC's *Framework for the Preparation and Presentation of Financial Statements* issued in 1989 and adopted by the IASB in 2001. While the list is currently included in the IASB's revised *Conceptual Framework,* some of its ideas are not reflected in the IASB's revisions to the *Framework*. For example, the IASB has changed the *Framework* to focus on the specific needs of investors and creditors in capital markets rather that the common needs of all users. I disagree with that change.

than the common needs of users. IFRS financial statements could, and sometimes do, disclose these adjusted measures, for example IAS 1 *Presentation of Financial Statements* requires disclosures about whether a reporting entity has complied with externally imposed capital requirements.

7. Some of the adjustments are the result of political decisions to favour or protect particular entities or other interested parties, for example some tax deductions are intended to encourage entities to incur capital expenditure and some regulatory capital requirements are intended to protect depositors and, hence, the stability of financial markets. Decisions about such matters are the province of democratically elected governments and agencies appointed by such governments. They are not the province of the IASB or many national standard setting bodies. The IASB should not, and should not be allowed to, write accounting standards which favour or protect particular entities or other interested parties. For example, the IASB should not be allowed to write accounting standards which seek to protect banks or the banking system, protect the interests of beneficiaries of pension plans, protect the leasing industry or achieve of particular levels of tax revenues for governments.[6] The same constraint should also apply to the UK's Financial Reporting Council (FRC).

The impairment of financial assets under the cost model under IFRS and UK GAAP

8. Some have asserted that IFRS requirements for the impairment of financial assets accounted for under the cost model differ from the equivalent UK GAAP requirements. They have also asserted that UK banks reported lower amounts of loans losses following the transition from UK GAAP to IFRS. There is no evidence to support these assertions. The evidence available by comparing the requirements of IFRS and UK GAAP[7] shows that:

   - both IFRS and UK GAAP require the use of an incurred loss model;
   - both IFRS and UK GAAP require the use of forward-looking measures to assess the impairment of financial assets accounted for under the cost model, that is they both require the reporting entity to estimate the expected *future* cash flows from those assets;
   - IFRS requires, but UK GAAP does not require, the reporting entity to discount those expected future cash flows to their present values at the balance sheet date;

[6] For a further explanation of these arguments, see the comments of the Financial Reporting Standards Committee of the European Accounting Association (EAA) on the paper on the effects of accounting standards prepared by the European Financial Reporting Advisory Group (EFRAG). These comments include a taxonomy of possible effects of accounting standards and distinguish between those effects that the standard setter should evaluate in making a standard setting decision and those of which the standard setter should be aware but not take into account. The EAA's comments have been published as "The Effects of Accounting Standards – A Comment", *European Accounting Review*, 9:2, pp113-125.

[7] As well as the requirements of IAS 39 *Financial Instruments: Recognition and Measurements* with those of the British Banking Association's *Statement of Recommended Practice on Advances* and UK company law, see also the following detailed, specialist guidance: Hitchins, J., Hogg, M. and Mallet, D., *Regulatory Accounting and Auditing Guide: Banking*, pp 455-457, ABG Professional Information for the ICAEW, London, 2001; Mann, F. and Michael, I., "Dynamic Provisioning: Issues and Application", in *Financial Stability Review*, pp128-136, December 2002, Bank of England.

- both IFRS and UK GAAP require the identification of losses that can be specifically identified at the reporting date and those which exist at the reporting date but which cannot be specifically identified; and
- both IFRS and UK GAAP require the estimate of future cash flows to be based on the facts and circumstances at the balance sheet date, including those facts and circumstances which are specific to the borrower (for example default or potential bankruptcy) and those which reflect national and local economic conditions.

9. Mann and Michael acknowledge that "in practice, some [UK] banks have established provisioning policies with forward-looking elements that attempt to cover some expected losses over the life of a loan" but suggest that this represents "only a relatively small part of total provisions" (partly for tax and Basel reasons). Hitchins, Hogg and Mallet report that the Bank of England raised the issue of accounting for expected losses in the mid-1990s but support was limited as it raised conceptual and legal difficulties (including conflicts with UK GAAP and the Companies Act 1985). Until recently, the IASB and its predecessor body had, not considered the use of an expected loss model but both bodies issued, or have been associated with, discussion papers[8] which proposed that loans and advances should be measured at fair value which would have meant that, among other things, some expected losses would have been recognised. In practice, therefore, neither UK GAAP nor IFRS currently require an expected loss model.

10. Until 1969, UK clearing banks used secret or hidden reserves to smooth their financial results. They were able to do this because the Companies Acts 1948 and 1967 exempted them from publishing "true and fair" financial statements. With effect from 1970, the UK clearing banks voluntarily ceased this practice and started publishing "true and fair" financial statements. The UK persuaded the EU to limit the use of hidden reserves in the EU *Bank Accounts Directive*. In the 1970s and 1980s, the UK accountancy profession and the Bank of England played a major part in persuading the IASB's predecessor body to prohibit the use of hidden reserves in the financial statements of banks. In practice, therefore, neither UK GAAP nor IFRS have, over the last 30 years, permitted the use of secret or hidden reserves.

11. The evidence provided by the disclosures made by UK banks on their transition from UK GAAP to IFRS[9] also supports the view that UK GAAP and IFRS have very similar requirements for the measurement of the impairment of financial assets accounted for under the cost model differ. Most UK banks made only small adjustments to their provisions for loan losses; some banks increased, rather than decreased, their provisions. Some UK banks increased their loan loss provisions because IFRS require that losses are measured by reference to the *present value* of expected future cash flows whereas UK GAAP allow them to be measured by reference to the undiscounted amounts of expected future cash flows. In this respect, IFRS are therefore more prudent than UK GAAP. Furthermore, under IFRS, some

---

[8] See *Accounting for Financial Assets and Financial Liabilities* issued by the IASC in 1997, the draft standard on financial instruments and similar items issued by the Joint Working Group of Standard Setters (which included the IASC and the UK's ASB) in 2000, and *Reducing Complexity in Accounting for Financial Instruments* issued by the IASB in 2008. All these proposals met strong opposition from the banking industry.

[9] See appendix 1

UK banks had to adopt more a prudent approach to the recognition of income on loans and advances.

12. The evidence that IFRS and UK GAAP are similar could indicate that UK banks applied IFRS wrongly but there is no published evidence to support such a conclusion. Of course, the evidence also does not show whether IFRS and UK GAAP requirements are "correct" but it does suggest that any accounting failures before and after the financial crisis would have occurred had UK banks continued to report under UK GAAP. It is time, therefore, to move on from the "IFRS blame game" and to focus on supporting the IASB and the FRC in their search for the "correct" answers to important accounting questions.

Responses to specific questions in panel's call for written evidence

Q10. What was the role of accounting standards and reliance on fair value principles in the banking crisis? What does a 'true and fair view' really represent to the market?

The role of accounting standards and reliance on fair value principles in the banking crisis

13. Some have asserted that accounting standards, in particular the use of fair value measurement, caused or played a major part in the financial crisis. There is little evidence to support these assertions. Regulatory and academic evidence shows that the assertions are unfounded[10]. The evidence also suggests that the major accounting issue arising from the financial crisis was the impairment of financial assets accounted for using the cost model rather than the losses arising from the use of fair value measurement.

What does a true and fair view really represent to the markets?

14. UK company law requires that the financial statements show a "a true and fair view of the state of affairs as at the end of the financial year and the profit or loss for the financial year"[11]. The law does not define a "true and fair view". Neither the FRC nor any its constituent bodies have defined a "true and fair view" but the FRC has obtained counsel's opinions on both the relationship between the "true and fair view" and accounting standards and on the status of the "true and fair view" following the adoption of IFRS by some UK companies.

15. The professional accountancy bodies in the UK have not issues any recent pronouncement on the meaning of "a true and fair view". The Institute of Chartered accountants of Scotland did publish in 1982 a monograph *A True and Fair View in Company Accounts* by Professor David Flint which is often quoted as an authoritative source and which concludes:

> "... accounts which are required to give a true and fair view should comply with specific statutory requirements of disclosure and presentation, and disclose the

[10] See, for example: Laux, C., and Leuz, C., 2010, "Did Fair Value Accounting Cause the Financial Crisis", *Journal of Economic Perspectives*, 24:1, pp93 to 118; Securities and Exchange Commission (SEC), 2008, *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-to-Market Accounting*, Washington DC

[11] Companies Act 2006, s404(2)

accounting policies and bases which have been adopted; they should ordinarily be prepared in accordance with normal accounting practice and in compliance with Statements of Standard Accounting Practice, recognising, however, that these are a means to an end and not the end itself. They should be prepared to satisfy the professional technical information requirements of what is necessary as a basis of opinion and decision on the part of those who may legitimately expect their needs to be met. They should meet both the general legal requirement for the protection of shareholders of full and frank disclosure of information on matters on which they ought to be informed in relation to the company's affairs, and the social expectation of what is necessary, judged against the ethical standards of society in communication with shareholders and other relevant groups."

While Professor Flint's terminology is somewhat dated and the nature and status of accounting standards has changed in the UK since 1982, his definition conveys much of what is still understood today by "a true and fair view".

16. The IASB uses the term "fair presentation" which IAS 1 *Presentation of Financial Statements* defines as[12]:

> "... faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the *Framework*."

IAS 1 goes on to assert[13]:

> "The application of IFRSs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation."

17. IFRS treat "fair presentation" as an overriding principle in the same way that the UK company law treats "a true and fair view" as an overriding principle. Both IAS 1 and UK company law require an entity to depart from a specific requirement when compliance with that requirement would not result in a "fair presentation" or "a true and fair view". IAS 1 states[14]:

> "In the extremely rare circumstances in which management concludes that compliance with a requirement in an IFRS would be so misleading that it would conflict with the objective of financial statements set out in the *Framework*, the entity shall depart from that requirement ..."

[12] IAS 1.15
[13] IAS 1.15
[14] IAS 1.19. Replacing the cross reference to the *Conceptual Framework* with the actual text on the objective of financial statements conveys a very strong message: "In the rare circumstance in which management concludes that compliance with a requirement in an IFRS would be so misleading that it would not provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity, the entity shall depart from that requirement ..."

18. While IFRS use "fair presentation" and UK company law uses "a true and fair view", the FRC has received a legal opinion that states that fair presentation in IAS 1 "is not a different requirement to that of showing a true and fair view but is a different articulation of the same concept"[15]. This opinion is consistent with the thinking of the IASB's predecessor body when it referred to "fair presentation" and "a true and fair view" in its *Framework for the Preparation and Presentation of Financial Statements* and when it issued IAS 1 in 1997.

19. While the use of the shorthand "a true and fair view" is common and understandable, it is important to acknowledge that UK company law requires financial statements to show a true and fair view *at the balance sheet date* and *in the period up to and including that date* (IFRS imply the same restriction to fair presentation). Therefore "true and fair" financial statements must reflect the transaction and other events that occur up to and including the balance sheet date. The financial statements must *not* reflect transactions and other events occurring after the balance sheet date that do *not* provide evidence about conditions at the balance sheet date[16]. Therefore, UK banks were correct in reporting the effects of the financial crisis that started in 2008 in their 2008 financial statements (they would also have been correct to do so had the financial crisis started early in 2008, that it before the banks issued their 2007 financial statements).

20. It is also important to acknowledge that it is generally accepted in the UK that the use of secret or hidden reserves to smooth profits does not result in a true and fair view. While UK clearing banks used secret or hidden reserves to smooth their profits until the late 1960s, they could do so only because the Companies Act 1948 exempted them (and some insurance and shipping entities) from the requirement to publish "true and fair" financial statements. While the meaning of "a true and fair view" has undoubtedly evolved over the ensuing forty years, the meaning has not evolved to permit the use of secret or hidden reserves.

Q11. What are your views on the current incurred-loss impairment model and its role in the banking crisis? Do you consider that proposals to move to an expected-loss model will address criticisms of the current accounting rules?

21. Both IFRS and UK currently require the incurred loss model for the measurement of the impairment of financial assets accounted for using the cost model (which includes the loans and advances of banks). The model is consistent with the requirement for financial statements to present fairly or show a true and fair view of the financial position at the balance sheet date and performance in the period up to and including that date. It is also consistent with the approach adopted for the measurement of the impairment of other assets (for example, goodwill, intangible assets, property, plant and equipment, inventories, pension assets, tax assets etc.). Academic research shows that these requirements lead to timely loss recognition.

22. Notwithstanding the benefits of the incurred loss model, it has been criticised for allowing banks to recognise loan losses later than some commentators want. It has also been

[15] Martin Moore QC, *The True and Fair Requirement Revisited*, paras 4(C) and 23 to 29, Opinion to the Financial Reporting Council, 21 April 2008

[16] See SSAP 17 *Accounting for Post Balance Sheet Events* and IAS 10 *Events After the Reporting Period*.

criticised because it allows the income statement to benefit from the risk premium charged to borrowers before it suffers from the effects of the related loan losses. The challenge for standard setters and others has been to find an appropriate model (an "expected loss model") which recognises loan losses earlier than they are recognised under the "incurred loss model" but in a way that does not impair fair presentation or a true and fair view at the balance sheet date or for the period ending on that date[17].

23. As explained in paragraph 8, the incurred loss model requires banks to estimate the present value of the expected future cash flows from the relevant financial assets. The estimates of expected future cash flows are based on the facts and circumstances at the balance sheet date, including both facts and circumstances that are specific to the borrower (for example default or potential bankruptcy) and national and local economic conditions that correlate with defaults. The model already requires a bank to recognise some losses which it expects to incur but which it has not yet identified.

24. For an expected loss model to be different from the incurred loss model it would, in practice, have to require a bank to either:

- use assumptions about future events when estimating expected future cash flows, for example future deteriorations in credit rating or a future worsening in economic circumstances; or
- recognise specified levels of loan losses for financial assets that share common characteristics, for example recognise x% loan losses for financial assets for which repayments are overdue by three months.

25. The IASB's current draft proposals follow the first option, that is they change the assumptions used when a bank estimates expected future cash flows. Depending on the circumstances, the proposals require an estimate of loan losses either in the next year or over the life-time of the financial assets. The IASB has tentatively decided to restrict the events that require an estimate of life-time losses to those circumstances in which "there has been significant deterioration in credit quality since initial recognition"[18].

26. Had the proposed model been applied by banks in 2007, I believe that it is unlikely that it would have shifted significant amount of losses from 2008 into 2007. Therefore, the IASB's proposals may not meet the expectations of some critics of the incurred loss model. In particular, they may not meet the expectations of all those critics who have been calling for (a return of) prudence or want a return of smoothing through the use of secret or hidden reserves. However, these critics have been unclear on what they do want and how what they may want is consistent with requirements for transparent financial information and fair presentation or a true and fair view.

---

[17] In June 2010, the Federation of European Accountants (FEE) published a comparison of alternative approaches including the incurred loss model, the expected loss model, the Spanish banking system model, methods used prior to IFRS, fair value measurement and the use of hidden reserves. See FEE, *Impairment of Financial Assets: The Expected Loss Model*, Brussels, 2010

[18] *IASB Update*, November 2012

27. My personal preference is to retain the incurred loss model (although I could live with the IASB's current draft proposals if they receive widespread support). In the case of banks (and some other financial institutions) I would require that the recognition in the financial statements of any additional amounts of provisions or reserves required by the banking regulator. These additional amounts should be presented prominently. They should also be presented separately from IFRS profit and IFRS assets, liabilities, income and expenses. For example, I prefer that the changes in these additional amounts are presented prominently as a deduction from, or addition to, the IFRS profit. They should not be treated as expenses or income that are included in the measurement of IFRS profit.

Q12. What is the best method of accounting for profits and losses in trading instruments? Are there any alternatives to mark-to-market or mark-to-model that might better represent a 'true and fair view'?

28. The only appropriate method of accounting for trading instruments is the measurement of those instruments at a defined current value (fair value) and the inclusion of the resulting changes in those values in profit or loss. This method was used by banks and investment companies and similar entities under UK GAAP and is required under IFRS for all entities (in practice, it has relatively little effect on many entities other than financial institutions). No other method provides useful information to users of the financial statements. No other method provides information about management's stewardship of the funds entrusted to it.

29. The use of the fair value model for trading instruments requires the use of valuation techniques (models) and inputs to those techniques. It is important to acknowledge that the use of valuation techniques or models is not unique to the accounting for trading instruments. The preparation of financial statements often requires the use of techniques and models, for example, models are used to estimate the depreciation, amortisation and impairment of non-current tangible and intangible assets. Models are used to measure the cost of inventories, to apply the effective interest rate method to financial assets and financial liabilities, and to measure pension liabilities. These models are a means to an end; they are not an end in themselves. IFRS 13 *Fair Value Measurement* now provides a robust basis for the selection and use of appropriate valuation techniques and the inputs to those techniques when measuring fair value.

30. Some advocate accounting for trading instruments using the cost model under which the instruments are measured at each balance sheet date at the lower of cost and market value. This method does not provide useful information about the entity's financial position and performance. It does it not measure management's stewardship of the funds entrusted to it. The method is also open to abuse because management can dispose of specific instruments and, therefore, selectively report profits (sometimes referred to as "gains-trading") or selectively control the amount of realised profits that are available for distribution or available for the payment of bonuses. The use of the cost model also tends to delay the recognition of losses because many of its advocates argue that "temporary" losses should not be recognised or that cost and market value should be compared at an aggregate, portfolio level rather than an individual investment level.

Q13. Did IFRS accounting standards contribute to a box-ticking culture to the exclusion of promoting transparency and a 'true and fair view' of the business?

31. Accountants use checklists in the same way that other professionals use checklists, that is as a starting point to remind them of any relevant requirements and the steps they must undertake to carry out a particular task. The proper use of IFRS accounting checklists does not replace the need for judgment in applying accounting standards, in fact checklists often highlight the areas in which judgement must be exercised. While several critics have suggested that IFRS have led to a box ticking culture, I am not aware of any evidence that the use of checklists has resulted in "wrong" accounting or the lack of appropriate judgements.

Q14. Do we need a special accounting regime for banks? If so, what should it look like?

32. No. The explosion of new financial instruments in the late 1980s led the IASB's predecessor body to conclude that it should develop a single financial instrument standard that applied to all financial instruments whether they were held by banks or by other entities. This approach continues to be followed. The approach probably causes greater problems for non-banks than it does for banks. In general, accounting standard should be developed for transactions and other events. They should not be developed for industries or sectors.

9 January 2013

Appendix 1: Comparison of Loan Loss Provisions Reported by Major UK Banks on Transition From UK GAAP to IFRS

1. This appendix compares the loan loss provisions reported by six major UK banks, all of which published IFRS financial statements for the first time for the calendar year 2005. All six banks took advantage of transitional requirements which allowed them not to restate 2004 (or earlier periods) for the effects of IAS 39 *Financial Instruments: Recognition and Measurement*.

2. The six banks first reported provisions for loan losses in accordance with IAS 39 on restating their 31 December 2004 balance sheets from UK GAAP to IFRS (table 1). This is the only date at which comparisons can be made. There are no comparisons for the loan loss expenses included in the income statement.

Table 1: Loan loss provisions 31/12/2004

	UK GAAP	*IFRS*	*Change*	*Change %*
Barclays	£2,613m	£2,637m	+£24m	+0.92
HSBC	$12,680m	$12,542m	-$138m	-1.09
HBOS	£2,509m	£2,494m	-£15m	-0.60
Lloyds TSB	£1,663m	£1,919m	+£256m	+15.39
Northern Rock	£127m	£124m	-£3m	-2.36
RBS	£4,063m	£4,145m	+£82m	+2.02

3. The large increase reported by LloydsTSB arose because IFRS requires, but UK GAAP does not require, the discount of the expected future cash flows to their present values at the balance sheet date. As LloydsTSB explained:

   > "Impairment principles under IFRS are similar to those followed by the group under UK GAAP, with the exception of the requirements to discount the expected future cash flows at the original effective interest rate when determining the provisioning requirement."[19]

   The disclosure implies that LloydsTSB made the same estimate of expected future cash flows under both UK GAAP and IFRS.

4. The reduction in loan loss provisions at HSBC related primarily to its consumer finance business. Under UK GAAP loan losses in the consumer finance business were recognised "in accordance with a predetermined overdue status"[20]. The adoption of the IFRS incurred loss model for the

[19] Lloyds TSB Group, annual report 2005, page 114
[20] HSBC annual report 2005, page 356.

consumer finance business resulted in the reinstatement of loans which had been written off under UK GAAP "but which, based on historical evidence, were recoverable"[21].

5. The disclosures made by some banks imply that other adjustments were made to the way in which they applied the effective interest rate method and, hence, measured the loans before the recognition of loan losses. For example, Northern Rock explained that under UK GAAP it recognised some loan fees as revenue when the loan was made. Under IFRS, it spread these fees over the life of the loans[22]. This change increased the amortised cost carrying amounts of loans as at 31 December 2004 by £199m[23].

[21] HSBC annual report 2005, page 356.
[22] Northern Rock, IFRS briefing, 13 May 2005, page 18
[23] Northern Rock annual report, page 100