GLOBAL riskupdate

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Also in this issue

- WHO MANAGES RISKS BETTER – BANKS OR INSURERS?
- ARE AUDITORS BREAKING COMPANY LAW RULES
- REASSESSING AND UPDATING CREDIT ANALYSIS AND MODELS
- THE CHANGING GLOBAL FINANCIAL MARKET
- THE IMPACT OF GETTING REGULATION WRONG

ARE AUDITORS BREAKING COMPANY LAW RULES?

Cormac Butler examines whether flaws in the International Accounting Standards contributed to the Operational Risk that led to many bank failures.

Evidence provided recently to the House of Lords who held an inquiry into the role of auditors in the banking crises has raised a few concerned eyebrows as it suggests that auditors are not complying with Company Law for which criminal penalties apply and their failure to do so may have contributed to the banking crises that engulfed what were once safe banks in the UK and Ireland.

Indeed some commentators argue that if this evidence stands up, auditors may face negligence claims and in extreme cases, a criminal investigation. The House of Lords heard that although the International Financial Reporting Standards (IFRS) allow insolvent banks to conceal or at least delay recognising losses company law certainly does not. Auditors must therefore not only comply with IFRS rules but give appropriate warnings to shareholders and investors that their bank may contain hidden losses or artificial profits – or face possible negligence claims.

There are significant differences between published accounts that meet the requirements of the International Financial Reporting Standards (IFRS) and statutory accounts that meet company law rules. Accounting experts have advised the inquiry that many auditors allowed banks to ignore prudence and to prepare published accounts which suggested that banks were viable and profitable when in reality, they were on the brink of a bailout. Prior to the IFRS which many European banks adopted in 2005, auditors and accountants were forced to apply the prudence concept when preparing accounts. Accountants revealed losses immediately but delayed the recognition of profits until they were 'realised' i.e. the asset producing the profit was sold. The IFRS were criticised for abandoning the prudence concept, allowing banks to conceal losses and record profits prematurely.

According to Professor Stella Fearnley who gave evidence to the House of Lords: **"Because of the increasingly specialist nature of banking business, a Statement of Recommended Practice (SORP) was issued by the British and Irish Bankers Association in the decade prior to 2005 and the introduction of IFRS. The SORP set out detailed accounting methods for banks which all banks were expected to follow. The SORP was entirely consistent with Company Law and set out how to account for mark to market and loan loss provisioning."** Professor Fearnley went on to observe that: **"The UK and Ireland, with the most comprehensive introduction of IFRS and IFRS style accounting in banking companies, have had the most non-investment bank collapses in the EU. There are now some concerns that FRS 26 does not match up with the UK capital maintenance rules and the requirement for prudence, which still applies under UK GAAP."**

If this evidence stands up, then the IFRS standard-setters, the International Accounting Standards Board will face severe criticism for promulgating accounting standards that encourage auditors to break company law rules. Many auditors have relaxed on the false assumption that by complying with IFRS, auditors automatically comply

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>
> *Professor Stella Fearnley*

with Company Law. The problem possibly stems from the fact that IFRS rules are copied from the US standards. Unlike the UK and Ireland however, there is no company law legislation in the US that prevents auditors from allowing banks to hide losses or claim to be solvent when in fact they are bankrupt.

According to Professor Fearnley **"Just after the regulation was issued in 2002, the Enron scandal broke and the US standard setter, the Financial Accounting Standards Board (FASB)**

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was heavily criticised. A member of the IASB was then appointed as chair of FASB. IASB then announced later in 2002, without public consultation, that it was going to converge its own standards with those of the US FASB".

This accounting change may have encouraged reckless banking activity. Banks for instance offering dangerous 125% mortgages at cheap interest rates almost certainly did not apply the prudence concept and possibly hid losses which is allowed under IFRS, but not under Company Law. Bankers who flocked into complex structured products and securitisations, often never bothered to value them once purchased and where they did, they used assumptions that in effect allowed them to record a profit under IFRS when in reality they suffered losses which were hidden. In Ireland, banks are still accused by the Irish government of continuing to hide losses. Indeed the chairman of the Irish Central Bank has criticised the accounting standards that allow banks to conceal losses. IFRS contributed to the problem that bankers paid themselves bonuses based on artificial profits when in reality, they engaged in reckless lending which brought the banks down.

The chairman of the Irish Central Bank is not the only person criticizing the auditing profession. The former Chancellor of the Exchequer Nigel Lawson has expressed surprise that no auditor was yet sued for the banking catastrophe. More recently, the former president of the Institute of Chartered Accountants Peter Wyman claimed that as far as bank audits were concerned, the IFRS rules were 'not fit for purpose'.

He states, **"The rules allowed banks to pay dividends and bonuses out of unrealised profits – from profits that were anything but certain. The system is still in place now – we can't tell if similar problems are building up because there is no requirement to separate realised from unrealised profits"**

Wyman is effectively putting the rest of the profession on notice that they are knowingly using accounting rules that don't work. This could expose accountants to negligence claims unless auditors warn shareholders that bankers are possibly hiding losses or recording profits based on biased judgements.

While risk experts, analysts and commentators have written reams of articles on Operational Risk few if any have highlighted the greatest source of Operational Risk since 2005. Bankers' bonuses are calculated on flawed information. Bankers are allowed to record profits and therefore pay bonuses on loss making transactions using IFRS rules. The result is that banks have lent recklessly, engaged in dangerous takeovers and invested in complicated lethal weapons of mass destruction, as described by Warren Buffett, which they don't understand. These instruments were kept off balance sheet by accountants who claimed that they were complying with IFRS and American accounting standards. If banks pay bonuses to people to wreck a bank in this way, the Operational risk is clear.

There is a negative correlation between bonuses and good risk management practices. Regulators will penalise banks who take on too much leverage and risk but as long as bonuses are paid for reckless lending bankers will buy leveraged structured products and keep them off balance sheet yet, the artificial profits from these transactions flowed into the Profit & Loss under flawed IFRS. Traders and bankers received bonuses, bonuses they would have been denied had auditors reported or even understood the requirements of IFRS 7 on financial risk disclosure. Bankers therefore are tempted not to measure risk properly, it's not good for bonuses. However, to hoodwink accountants and regulators, they give appearances that they are doing so.

Few in the profession could argue against the view that significant changes in the accounting rules are urgently required. Accountants will have to try and understand the economics of the underlying transactions and therefore need to enhance their training and knowledge of financial instruments along with a realistic appraisal of what drives operational risk.

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