Stephen Haddrill,
Chief Executive,
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8th Floor
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29 November 2016

Dear Sir,

International Financial Reporting Standards

In July 2011 the Economic Affairs Committee published a report, Auditors: market concentration and their role. One of the concerns raised by the Committee was the effects on accounting and audit of the International Financial Reporting Standards (IFRS). The Committee concluded:

“Standards for use in many countries need clear rules which all can apply. It follows that IFRS is more rules-based than UK GAAP. But we are concerned by evidence that, by limiting auditors’ scope to exercise prudent judgment, IFRS is an inferior system which offers less assurance. IFRS also has specific defects, such as its inability to account for expected losses. The weaknesses of IFRS are especially serious in relation to bank audits.

“We recommend that the profession, regulators and the Government should all seek ways to defend and promote the exercise of auditors’ traditional, prudent scepticism. The Government should reassert the vital role of prudence in audit in the UK, whatever the accounting standard, and emphasise the importance of the going concern statement.

“As it revises banking regulation, we recommend that the Government should have the importance of accounting standards at the forefront of its mind. It should promote a prudent interpretation of IFRS as applied to banks. This would include sober valuation of complex financial instruments. At present IFRS permits recognition only of incurred losses, not expected losses. So it is essential that banks put aside reserves in good times to provide against downturns. This would have the incidental advantage of reducing the scope for banks to pay bonuses on the basis of profits struck without taking account of possible losses. We recognise that a fully satisfactory outcome depends on international negotiation and believe that the Government should give a lead.”

In July 2014 you appeared before the Committee with Sir Winfried Bischoff and provided a helpful update on the work of the Financial Reporting Council (FRC). During this session the Committee raised the issue of accounting standards. This letter follows up on two aspects of your evidence in the light of recent developments: (1) the potential conflict between the
IFRS and UK company law and (2) the concept of prudence. The Committee would be assisted by your answers to the questions below.

Conflict of law
In evidence to the Committee’s 2011 inquiry, some witnesses claimed that a conflict exists between section 393 Companies Act 2006 that requires company directors to only approve accounts that present a true and fair view of a business’s assets, liabilities, financial position and profit or loss and IFRS Standard IAS39. As you will be aware, in April 2013 a group of investors obtained an Opinion from George Bompas QC supporting this view. The Committee asked you about this conflict:

"The Chairman: Can I come back to the possible conflict between the IFRS and company law? As I understand it, the local authority got an opinion from George Bompas who said that there was a clear conflict and, further, that the FRC’s view that the true and fair view did not encompass distributable profits was incorrect. We are not here to try to judge one or the other, but what steps are you taking to resolve what could be quite a serious problem?"

"Stephen Haddrell: We did two things. First, we took our own legal advice from Martin Moore QC, who concluded almost exactly the opposite of what Mr Bompas had concluded. 21 Secondly, we asked the Government also to review this, because after all a matter of company law is a matter for the Government rather than for the regulator. Government’s lawyers also looked at it and concluded that they agreed with Martin Moore’s opinion. The Minister issued a statement, as did we, a year or so ago to that effect in order to clarify the matter for the market. So we feel that the matter is resolved. I do not think that the local authority pension funds feel that it is resolved, but we feel that we have done what we needed to do."

Since your appearance, the Local Authority Pension Fund Forum has obtained a second Opinion from Mr Bompas (August 2015) and, recently, written to company directors stating they should disregard regulatory advice over the application of accounting standards when deciding the level of dividends (October 2016).

Whilst the Committee does not seek to judge which of the two legal views are correct, the continuing uncertainty over this issue is a cause for concern.

(1) Does the 2015 Opinion of George Bompas QC alter the view of the FRC (as expressed by Baroness Hogg on 3 October 2013) that on this issue “concerns expressed by some are misconceived”?

(2) Does the FRC intend to take any further steps, for example obtaining any further legal advice, to clarify or resolve this difference of opinion and the uncertainty created by it?

Prudence and the IFRS
In July 2014 you were also asked whether the concept of ‘prudence’ would be reinserted into the conceptual framework used by the International Accounting Standards Board when writing the IFRS. You stated that:

"The conceptual framework of the International Accounting Standards Board is the criteria that it uses when it is writing the standards. It has agreed to put “prudent” back into the criteria but then it has to flow through into the rewriting of standards and so on over time."
(3) What progress has been made on this issue? In particular do you expect the concept of prudence to be incorporated into the main body of the framework?

(4) Are you satisfied with the International Accounting Standards Board's definition of prudence, or do you consider a more conservative definition should be adopted?

Yours sincerely,

(Hollick)

Chairman of the Economic Affairs Committee