Local Authority Pension Fund Forum

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Leading Counsel confirms substantial legal problems with accounting standards, and those applicable to UK banks in particular

The Local Authority Pension Fund Forum (LAPFF) has called for a full review of the process of setting accounting standards having received Counsel's opinion which confirms substantial legal flaws with International Financial Reporting Standards (IFRS).

LAPFF was part of a group of investors which sought the opinion of leading Counsel George Bompas QC of Lincolns Inn. In addition to the Forum, the investors sought the opinion were, Universities Superannuation Scheme, Threadneedle Asset Management and the UK Shareholders Association. The opinion suggests that directors must override IFRS in order to comply with existent company law. The opinion also finds that directors may need to ignore the legal advice obtained by the Financial Reporting Council (FRC) on this issue.

The issues identified in the opinion raise fundamental concerns about accounting practices in recent years, which have had a particularly damaging effect on the banking sectors in the UK and Ireland. This in turn raises significant questions about the decisions taken by bank directors which, in LAPFF's view, were based on faulty numbers produced under the IFRS framework.

The Forum is therefore calling for a full review into how the defective standards were adopted, including an investigation into whether the existing financial reporting regime requires fundamental structural reform. LAPFF also believes that the role that accounting firms played in both setting the accounting standards and signing off faulty accounts must be properly scrutinised.

Given the significance of the opinion, the investor group submitted it immediately to the Parliamentary Commission on Banking Standards (PCBS) and agreed not to make it public until the Commission produced its final report today.

Forum chairman Cllr Kieran Quinn said: "Over the past two years LAPFF has repeatedly made clear its view that the IFRS framework is legally faulty. The FRC has consistently denied that. However, this opinion suggests that something has indeed gone very badly wrong in the standard setting process, leading to the conclusion that IFRS should be overridden."

"These are extremely significant issues, given that they directly affect the accounting practices of systemically important financial institutions, and in turn affect the decisions made by those institutions, including the legitimacy of dividends paid since 2005. This also suggests that the accounts used for banks' rights issues were in fact defective."

"LAPFF welcomes the PCBS suggestion of a review of the method by which IFRS was introduced in the EU. The Forum also believes the role of accounting firms in signing off accounts that did not comply with law must be scrutinised, as must the involvement of particular firms in setting these defective standards."

LAPFF highlights the following key point from the opinion -

- in his opinion the specified accounting outcomes required by IAS 39 (the standard particularly applicable to banks) are contrary to the true and fair view requirement of the law (para 10.1 and 11.1). These being;
    - marking up to model profit taking and marking up to market,
    - not accounting for likely losses,
    - not dealing with the distributability of profits (i.e. whether they are realised or not and whether expected losses have been accounted for properly)
- in his opinion these defective accounting outcomes of IFRS should be overridden by invoking the overriding true and fair view requirment of the law (para 10.2 11.2),

On this basis the accounts of banks have been faulty since 2005, or even earlier, given that some IFRS measures had been incorporated early into Accounting Standards Board standards.

The opinion also raises significant questions about how the FRC has dealt with the matter:-

- Mr Bompas cannot reach the same conclusions as the legal advice obtained by the FRC. He cannot reach the same conclusion as at the time of that opinion (para 54, 55), and further the opinion is also out of date (para 7), Local Authority Pension Fund Forum

- Mr Bompas notes that the FRC continues to publicise its advice on its website. (para 56) He is concerned that directors may in fact not be able to rely on it in discharging their statutory obligations to not approve accounts that do not give a true and fair view (para 63),

He also raises the question of the EU's adoption process:

- a defective accounting standard could be challenged on the grounds of "illegality….on the grounds of lack of competence and infringment of an essential proceedural requirement…the failure of the adopted standard to satisfy the threshold condition in Article 3(2) of the IAS Regulation".

LAPFF has consistently been concerned not only with the quality and effect of IFRS, adopted in the EU in 2005, which can cause insolvent and loss making banks to appear solvent and profitable, but whether IFRS adoption by the EU was contrary to the "true and fair view test" required by EU and UK law.

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About LAPFF:

The Local Authority Pension Fund Forum (LAPFF, www.lapfforum.org), which was set up in 1991, is a voluntary association of 56 public sector pension funds based in the UK. It exists 'to promote the long-term investment interests of local authority pension funds, and to maximise their influence as shareholders to promote corporate responsibility and high standards of corporate governance amongst the companies in which they invest.' The Forum's members currently have combined assets of over £115 billion. PIRC is the Research and Engagement partner of the Forum.

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