IAS 1 Consultation
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Response to the IAS 1 Consultation – ED/2019/7

Background

The Local Authority Pension Fund Forum is a voluntary association of 82 local authority pension funds and six LGPS pool companies, based in the UK with combined assets of approximately £300 billion. It exists to promote the investment interests of the funds, and to maximise their influence as shareholders to promote high standards of corporate governance and corporate responsibility amongst the companies in which they invest. Issues on accounting and audit have been a concern since the introduction of International Accounting Standards ('IAS'/'IFRS') and the banking crisis.

Summary

LAPFF believes that some of the revisions to IAS 1 are necessary as proposed. However the Forum also considers that further substantial changes are also necessary which have not been proposed and that IAS 1 as it stands is un-endorseable. A list of some necessary changes is given in the answer to Question 14. Further to Brexit, each new International Financial Reporting Standard (IFRS) is now required to be endorsed as consistent with UK law by the Secretary of State with an affirmation by the UK Parliament.

This response is comprehensive and it will be provided to Parliament.

A key issue is the **role and function of accounts** - as set out in IAS 1 para 20 and Question 8.

IAS 1 is defective on this matter, and is also defective as this creates a limitation of scope for auditors. A recent Parliamentary enquiry by the Business Energy and Industrial Strategy Select Committee concluded that IFRS creates a 'delivery gap' - which is being passed off as an 'expectations gap' - because of the mismatch between the standards and the law[1].

The law requires **reliable** accounts for:

- stewardship (holding boards to account) and
- a capital maintenance function which is firmly grounded in rational economic logic for the public interest given that companies have limited liability.

[1] See later for details

Both of these are governance functions. However, instead of that, IFRS has a model of ‘useful for users’ (ostensibly parties trading shares). The arbitrary ‘useful for users’ approach has a track record of producing defective standards and defective accounts, partly because ‘useful for users’ doesn’t mean anything concrete. It also overlaps with a multitude of other information more relevant to share pricing, such as forecasts. The Companies Act model is designed to satisfy ‘long only’ investors, the shareholders as a body and creditors. The IFRS ‘users’ model subordinates that to a multitude of ‘users’ including parties who may have an interest in bad accounts, such as short sellers and traders of share price volatility.

The differences between IFRS and the law can be summarised thus:

Objective	**Governance Purpose A**	**Governance Purpose B**	**Purpose C**
	Accountability to hold management to account	**Capital maintenance**	**Useful to third parties**
	For the Company itself (shareholders and creditors)		
Company law in UK	Yes	Yes	Yes, and as a result of the other two objectives.
IFRS	No. The IFRS model locks in management assertions in unchallengeable ways.	No. And indeed can be contrary to it. There is a lack of prudence.	This ostensibly is the purpose of IFRS, but it is **not useful to the shareholders and creditors**, and hence not useful to third parties either. (Though some parties may find unreliable accounts advantageous, e.g. parties who trade volatility)
	The IFRS model plays to 1) auditors used to serving management rather than holding them to account 2) avoids capital maintenance which by necessity includes fraudulent loss and lack of control. **The IFRS system is role changing.**		

The proper legal purpose deals with the real world issue of whether the accounts are sufficiently robust to maintain capital and justify dividends (capital maintenance) on a going concern basis.

Because IFRS is deliberately excluding Governance Purpose A and Governance Purpose B, it's not surprising that it will produce defective outcomes, including accounts which can make insolvent companies appear to be healthy going concerns[2].

In 2019, a Committee of the UK Parliament was unable to get the representatives of the Big Four firms to set out the law properly. Only Mazars (a French firm operating in the UK) articulated the legal position correctly.

Another problem is that IAS 1 is factually incorrect on what **equity** is, which reflects a pattern of the International Accounting Standards Board (IASB) changing the meaning of words of the English language.

IFRS was promoted globally from 2005 on the claim that the IFRS system achieved **comparability between** the accounts of companies, but this consultation on IAS 1 now admits it doesn't.

IAS 1 is also poor in dealing with the **going concern** basis of accounting. The objective question of whether the accounts have been properly prepared on a going concern basis, is restricted in IAS 1 by the conditional test of whether the management considered it appropriate or not, thus limiting the scope of the other party involved, the auditor, to reach an **independent** conclusion.

Whether a company is a going concern isn't in the gift of management, but is dependent on whether shareholders and creditors wish to continue to finance it, which in turn depends on its **true condition**, something which management may be trying to conceal. An added problem is that an otherwise sound company management may be getting the wrong information due to problems with IFRS accounts.

A set of company law accounts regards a balance sheet as a statements of <u>historic cost</u> assets, showing how they **are funded** by shareholders funds and liabilities (if assets are valued upwards, no one **funded it**, so a revaluation reserve (not distributable) is shown as the 'funding'. That's relevant to whether the company can continue <u>to be funded</u>. The IFRS model is a hotchpotch of various valuation models that value assets and liabilities losing sight of the concept of 'funding'. That creates blind spots on going concern, solvency and

[2] See a list of some problems in Appendix A

paying dividends. It’s disconnected from the fact that cash and funding drive businesses forwards, or a lack of cash and funding drives it backwards. It is the reason why businesses with a set of IFRS accounts that appear healthy can suddenly collapse (e.g. Carillion and banks in the banking crisis).

The fallacy of using a balance sheet to ‘value’ assets and liabilities (the model that the IASB has pursued) was shown as such by the UK Parliament in 1946, and again in 1962. The Cohen Committee of 1945 stated[3]:

“Moreover, if a balance sheet were to attempt to show the net worth of the undertaking, the fixed assets would require to be re-valued at frequent intervals and the information thus given would be deceptive since ***the value of such assets while the company is a going concern will in most cases have no relation to their value if the undertaking falls***[4]”.

That analysts were prone to be taken in by this fallacy (and the IASB has been reliant on a group of analysts to further its approach) is reiterated in the Jenkins Committee Report of 1962[5]:

“As the Cohen Committee pointed out at paragraph 98 of their Report, that is not the function of a balance sheet and indeed ***a balance sheet prepared on that basis could be seriously misleading except when the company is about to be liquidated.*** *The proper function is admirably explained in the following passage from the Recommendations on Accounting Principles issued to its members by the Institute of Chartered Accountants in England and Wales (which we quote at length because we think that the function of company accounts may not be fully appreciated by* ***those investors unfamiliar with accounting principles and practice****)”:*

As pointed out later, not only has the IASB drawn on the resources of analysts who agree with its model, but many of those analysts have essentially been trained to think in terms of that model by the ‘Corporate Reporting Users Forum which is run by PwC.

In its recent rights issue prospectus, Whitbread plc has very helpfully disclosed that bondholder covenants require non-IFRS numbers which is a clear indication that IFRS is not fit for purpose for suppliers of finance. Not all companies are as candid as that.

3

4 Paragraph 98, of the Cohen Committee Report to Parliament 1945

5 Paragraph 133 of the Jenkins Committee Report to Parliament 1962

LAPFF also sets out observations that the problems with the IFRS system are rooted in regulatory capture.

The Parliamentary enquiry[6] demonstrated that a proper discussion about **the function and reliability** of accounts ultimately gets into matters of auditor liability and negligence and the accounting profession didn't like talking about it and used the artificial construct of 'an expectations gap' instead.

It is clear there has never been such candid discussion as was undertaken in the Parliamentary enquiry, within the IASB or its Trustees. Indeed, how could it be, given that the IASB was set up by the very auditing firms promoting the 'expectations gap'.

Similarly, the construct of accounts serving a role to hold boards to account doesn't fit with Big Four firms trying to sell consultancy, tax, corporate finance and other services at the same time as being auditors.

IAS 1 is unendorseable in the UK. It serves the wrong purpose

The Exposure Draft ('ED') results in the amendment of IAS 1 and **all of IAS 1** will need to be endorsed. It's difficult to see how the Secretary of State and Parliament can endorse a standard which is contrary to the applicable law in many respects.

This was also the conclusion of the Parliamentary Committee in 2019 following the collapse of Carillion plc (audited by KPMG for 19 years).

"At its heart, the divergence between IFRS and the law is that the overriding principle behind IFRS is neutrality, whereas the overriding principle behind the law is prudence. The two can be wildly different at times, as exemplified by Carillion. We cannot unilaterally reform the international standards, but we can ensure that prudence remains at the heart of the law. Prudence leaves companies better capitalised, and so more resilient to shocks[7]."

Paragraph 20 of this Exposure Draft makes a definitive statement as to the role of accounts as one of being 'useful' to third parties. In doing so Paragraph 20 excludes the function of accounts that Parliament has decided is not merely

[6] See below
[7] https://publications.parliament.uk/pa/cm201719/cmselect/cmbeis/1718/1718.pdf

‘useful’ but **essential** for **the company** itself, the company being the body of members, with duties to creditors.

The function that Paragraph 20 omits is the ‘stewardship’ function for capital maintenance, the function which requires **robust** numbers, and a **robust** going concern position. The ED consultation does not deal with this defect. The issue of robustness in UK law falls onto the auditor in last resort.

At the recent Parliamentary enquiry only Ms. Jac Berry a partner of Mazars properly answered to the Parliamentary Committee on this matter. The Big Four firms were confused. This is from the final report[8]

“Jac Berry from Mazars was very clear that the [IFRS] standards do not deliver the law. She said that part of the auditor’s role is to make sure that companies adhere to relevant laws and regulations.”

“In oral evidence there was some confusion among the Big Four on this issue. The heads of KPMG and EY explicitly said they thought the standards [IFRS] delivered the law, and the head of Deloitte agreed with them. The head of PwC said he was not an auditor, but generally trusted that his firm complied with whatever the law was.”

Jac Berry’s position was proveably correct as a concurrent auditor negligence case in the Courts was decided in the middle of the Parliamentary enquiry. That case involved capital maintenance – unlawful dividends.

The capital maintenance model of UK law, requires reliable accounts to a particular standard, it has firm expectations even when defects in accounts are due to fraud and auditors missed it.[9] The 2019 court decision didn’t even change the law, it merely followed a pre-1967 position that is so definitive that auditors cases tend to settle out of court.

In the UK, auditors have to give an opinion of last resort on accounts for capital maintenance purposes even if they have qualified the accounts[10]. But because IFRS runs with a model different to that required by the law, it is not possible to rely on the auditor opinion of **even unqualified accounts**. (See Appendix A for examples of ‘profits’ that are not profits and ‘assets’ that are not assets and with liabilities excluded).

[8] Para 72 and 73: https://publications.parliament.uk/pa/cm201719/cmselect/cmbeis/1718/1718.pdf
[9] Asset Co v Grant Thornton 2019 EW HC 150.
[10] Section 837(4) Companies Act 2006

The BEIS Select Committee in 2019 recognised this and stated:-

'If auditors delivered on the existing regime reliably and well, the expectation gap would shrink greatly. The delivery gap is far wider than the expectation gap and that is what must be fixed as soon as possible[11].'

'AssetCo: on 31 January 2019, the High Court ordered Grant Thornton to pay a record £21 million in damages for "negligence of the highest order" and "flagrant breaches of duty" in relation to its audits of AssetCo in 2009 and 2010. One of these breaches concerned capital maintenance.'

'An important requirement of the Act is capital maintenance. Companies can only pay dividends out of past, realised profits available for distribution in the company's 'distributable' reserves. Distributions to shareholders must be justified by reference to 'relevant accounts'—normally the company's last annual accounts.

'A company can only rely on its annual accounts to make a distribution if they have been "properly prepared" in accordance with the provisions of the Act. The auditors must have made their report on the accounts (unless the company is exempt from audit). If the auditor expresses a negative opinion on the accounts, a company cannot rely on its annual accounts to justify a distribution without a further opinion from the auditor on the effect of the matters at issue on the ability of the company to make a distribution.'

We also question how the large accounting firms are able to obtain professional indemnity insurance in accordance with the law if the accounting standards they are following don't deliver the outcomes required under the law.

As the Parliamentary enquiry stated, the tool to deliver capital maintenance is the accounting principle of **prudence**. That means booking likely losses and foreseeable liabilities and not booking unrealized profits.

However, instead of debating prudence properly the IASB changed its interpretation to result in a different meaning that is easier to reject[12], i.e. equating prudence with overly pessimistic valuations of assets and liabilities. That is an incorrect linkage. Prudence defines what falls to be valued, not the method of valuation.

[11] https://publications.parliament.uk/pa/cm201719/cmselect/cmbeis/1718/1718.pdf
[12] http://archive.ifrs.org/Investor-resources/Investor-perspectives-2/Documents/Prudence_Investor-Perspective_Conceptual-FW.PDF

Prudence, as the Parliamentary enquiry stated, helps protect companies to withstand shocks as they are better capitalized. IFRS can create false impressions of capital (e.g. including tax losses as an asset).

IAS 1 is also fundamentally defective on the matter of going concern. IAS 1 para 6K states:-

*"An entity shall prepare financial statements on a going concern basis unless management either **intends** to liquidate the entity or to cease trading, or has no realistic alternative but to do so."*

That statement misses the point. Whether a business is a going concern depends on whether it can continue to be funded or not. That is determined by the state of the company and the position of its shareholders and creditors in wishing to *maintain or extend* funding.

One reason that a business might not be a going concern may be because the management are concealing a fraud and the auditor has missed it. IAS 1 confuses management intent with the de facto position **of the company**. Under UK law the auditor cannot hide behind management assertions. IAS 1 also has a test of management awareness which creates a model where auditors can rely on management. IAS 1 states:-

'***When** management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, the entity shall disclose those uncertainties.'*

One would not expect a manual for independent public health inspections of restaurants to defer to the assertions of the management. But IAS 1 does just that.

Through such devices the IFRS system is changing (without a legal basis to do so, and running up against national laws) the responsibilities of the relevant actors in the preparation and auditing of accounts.

The fundamental problem with IFRS is exemplified on the matter of going concern, because whether a company is a going concern or not depends on its capital, profit generation **and** the state of financial control, not the secondary matters of managements' intent and awareness. IFRS provides confusion and obfuscation on every one of these components.

It cannot be a coincidence that each area where IFRS is defective is relevant to issues in auditor defence cases, lack of proper profits, lack of capital, fraud, and, due to any or all of these issues, getting the going concern judgment wrong.

Essential to an analysis of IFRS isn't trying to understand what the conceptual theory is trying to achieve, but rather what it is trying to avoid.

IFRS is not comparable and IAS 1 has changed the meaning of words

A pillar of the IFRS system is the proposition that it delivers 'comparability' between the accounts of companies, para 97 of IAS 1 states that, and in a speech on 20th June 2019, Mr. Hoogervorst, the chair of the IASB said IFRS was comparable:

*"Because **of the comparability** and **discipline** of our Standards, **the income statement** according to IFRS Standards will always remain the main anchor for investors in **predicting future cash flows**[13]."*

However, that has never been achieved due to the fact, as this consultation admits, IAS 1 allows companies freedom to change the headings, titles and the order of items in the profit and loss account (income statement) and balance sheet (statement of financial position).

IAS 1 does not have robust 'proformas' for presenting accounts, with the result that management can decide the formats of IFRS accounts. One result of this is the proliferation of non-GAAP numbers such as EBITDA (earnings before interest, tax, depreciation and amortization) appearing in accounts, whilst not presenting a number for operating profit.

Furthermore (see response to Q 9) IFRS doesn't actually help assist in 'predicting future cash flows' either. The recently introduced standard IFRS 16 (leases) replaces a cash flow of a rental payment with a non-cash cost of depreciation instead. This gives a very misleading impression of cash flow from operating profits.

The requirements of the UK Companies Act, which preceded IFRS, set out fixed formats, proformas essentially. These contain requirements for a defined order and nomenclature for the headings, totals, and even the notes to the accounts[14].

[13] https://www.ifrs.org/news-and-events/2019/06/strengthening-the-relevance-of-financial-reporting/
[14] http://www.legislation.gov.uk/uksi/2008/410/contents

The Companies Act model also uses plain English definitive terms. But IAS 1 is even incorrect as to what the word ‘equity’ means!

For example at B14 (e) IAS1 states that share premium and reserves are classes of equity. They are not a class. Ordinary share capital is a class of equity, preference share capital is class of equity. A share premium arises when new share capital is issued, and any surplus over par value is put to the share premium account, it is not a class of equity. Similarly the ownership of reserves will attach to one class of share capital or other. Reserves are not a class of equity. Equity is a term to convey how share capital is divided into equal parts with equal rights for that class.

Because of the confusion in IFRS as to what the word ‘equity’ means, with the added flexibility offered in IAS 1 to presenting it, it is not immediately obvious from some IFRS accounts what the ordinary share capital interest in a company actually is.

Regulators of banks have come up with the term ‘Core Tier 1 equity’ to try to deal with the problem, but the matter flows from the poor disclosure under IFRS. Furthermore not all companies are banks, so there is not a regulatory number to deal with the problem outside of banks.

A similar case of IAS 1 using English wrongly is at para 4, with the statement *“Other IFRS Standards set out the recognition, measurement, presentation and disclosure requirements for specific transactions and other events”.*

By that, IFRS requires assets and liabilities to be ‘measured’. But the word measurement in English means the dimension of, or the act of measuring, something. Distance is measured, speed is measured. Financial assets have a cost or value which tend to be about prices, they don’t have a measurement. A car’s value isn’t a measurement; the cost, or value, of a building isn’t a measurement nor is the amount of cash in a bank account a measurement.

LAPFF has found that financial literacy cannot be taken as a given in the investment industry. It’s not helped if an accounting standard setter is giving things as fundamental as share capital the wrong name and avoiding terms such as cost and valuation by using the term ‘measurement’ instead.

The poor use of English in the IFRS system needs to be addressed. The issue of changing the meaning of words is well described in ‘Alice in Wonderland’.

"When I use a word," Humpty Dumpty said, in rather a scornful tone, "it means just what I choose it to mean—neither more nor less." "The question

is," said Alice, "whether you can make words mean so many different things." "The question is," said Humpty Dumpty, "which is to be master—that's all".

It is clear that the international accounting firms have been the 'master'. Those firms set up the IASB (as the International Accounting Standards Committee), funded and set up the Trustee structure.

IFRS and its roots in regulatory capture

LAPFF tends to side with critics of the thinking of standard setters who include veteran investor Charlie Munger the Chief Investment Officer of Berkshire Hathaway[15].

LAPFF has therefore not been convinced by the argument that IFRS is supported by 'investors'. Rather, vested interests have been co-opted and rallied to give the appearance of support for IFRS and the IASB.

The IASB has been represented from a 'user' perspective by the sell-side who still did or had worked for investment banks. Also, where 'investor' views are represented within the IASB's wider structures of advisory groups, they would tend to be people who agreed with the model IFRS is based upon.

The 'Corporate Reporting Users Forum' (CRUF) (hosted by PwC) has been a common source of people purportedly representing 'users' for the IASB and until recently, also for the UK's Financial Reporting Council and European Financial Reporting Advisory Group (EFRAG).

The overt position of the CRUF as an investor led group concerned with financial reporting (not audit) was betrayed by the fact that PwC tried to use the CRUF membership to lobby against Competition Commission proposals to deal with auditor independence.[16]

Similarly, when investors were asked to appear before the 2019 Parliamentary Enquiry, the public affairs partner of one of the Big Four firms contacted them to try to co-ordinate messages given to the Enquiry. Given that the Big Four

[15] See his writing as a parody in a state called Boneheadia https://slate.com/business/2011/07/charles-munger-s-parody-a-story-about-wantmore-tweakmore-totalscum-and-the-tragedy-of-the-great-recession.html

[16] This is covered by an article in the Independent. https://www.independent.co.uk/news/business/news/exclusive-pwc-links-to-independent-anti-reform-lobbyist-revealed-8718770.html

firms were getting the position on the law wrong, there was clearly a risk that position would be echoed by anyone taking their advice.

Lay members of the IASB may well – given the relationship with the accountancy profession – be running with exactly the same false assertions that the UK Parliamentary Committee successfully refuted, i.e. the IASB is setting standards that **accentuate the 'expectation gap'** -– rather than follow the law.

Indeed despite the clarity that the UK Parliament gave refuting the 'expectations gap' a document from KPMG International is still promoting it.[17]

*'any changes to the auditor's reporting model should add value and clarity -- versus **creating investor misunderstanding or expanding the "expectations gap**" in terms of what an audit does and does not do.'*

It is relevant therefore to bring up that IAS 1 was drafted by Henry Benson, the former head of Coopers & Lybrand and founder of the IASB. It is clear, from LAPFF research from Institute of Chartered Accountants in England and Wales material, that he pursued a path which gave rise to a form of "true and fair view" which did not accord with that of Parliament or the judiciary[18].

That firm then seems to have encouraged accounting academia to run with that model rather than the correct legal form[19.] It was also Henry Benson who led that firm and then the rest of the auditing sector into management consulting and other services, precisely the direction that the UK Government and Regulators are seeking to reverse.

Similarly, the 'internal control' model that Henry Benson and his firm promulgated, and the IFRS system it is based on, asserted that fraud was 'not the responsibility of auditors' and there was an 'expectation gap' regarding auditor duties, hence the expected quality of accounts.

This response from LAPFF therefore tackles the issues on the basis that the IASB was founded as a creature of regulatory capture and indeed is still highly dependent, at 27% of income[20], on voluntary donations from the large accounting firms.

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17 The Future of Audit https://assets.kpmg/content/dam/kpmg/sg/pdf/2019/05/the-future-of-audit.pdf

18 See "Sorry Wrong Number" LAPFF 2015 . http://www.lapfforum.org/wp-content/Archive/files/PostMortemIIIDEC2015TOPRINT.PDF

19 Ibid.

20 https://www.accaglobal.com/my/en/member/member/accounting-business/2018/07/in-focus/iasb-funding.html

The position of the IASB is not unique. The UK's Financial Reporting Council was criticized for years for being too closely aligned with the interests of the accounting firms, and is in the process of being replaced as a result. For 15 years it claimed to be a private sector body. Freedom of Information Act requests showed it has been a public body since 1992.

The fact that the IASB argues that national laws are not the responsibility of the IASB doesn't carry much weight with LAPFF. The capital maintenance regime of UK company law is merely the statutory codification of rational economic logic. Many regimes have dealt with the same logic in the same way. The French Civil Code is similar for example. Most of the Commonwealth is similar to the UK. The 'cuckoo in the nest' is the IFRS system which appears to be largely based on assertions rather than logic, has inherent self contradictions, and doesn't sit with law and practice.

The line that the IASB can't consider local law, but the interest of 'users', seems to be merely the result of an architecture for standard setting deeply rooted in regulatory capture, i.e. to avoid accountability under national laws which do follow rational economics.

The IFRS Foundation is entirely self-governing and unaccountable, but defines the scope of accounting standards. Therefore the party to have limited its scope is itself. The same can be seen in other aspects of the public interest, an example is this statement from the IASB's chair:-

"Our Standards do not seek to portray the contribution of a company to the public good, but to provide information that helps investors in their efforts to <u>predict future cash flow</u> of the company itself. So, CSR-like sustainability reporting does not meet the objectives of financial reporting, although there may be some overlap in practice." ***Speech of the IASB Chair, April 2019****.*

Ironically, the IFRS isn't delivering either to a model which sits with the claim that future cash flows can be predicted from IFRS information.

The IFRS Foundation has always had a serving, or former, Big Four partner on it.

We will therefore also be writing to ask the Trustees:

- why are the Big Four firms always represented as Trustees of the IFRS Foundation and on the IASB, or recent alumni of those firms?

- why in the light of the inaccuracies given to Parliament would the Trustees want them to be there?
- how many of the Trustees have ever undertaken their own or solicited independent research to assess whether what they have been told by the Big Four firms (or parties that repeat what they say) is true?
- why has IFRS been promoted globally on the basis it is comparable when this consultation admits it isn't?
- do they agree that circumstances, not merely the intent of management, determines whether a company is a going concern or not?

The BEIS Select Committee said this of KPMG:

"KPMG audited Carillion for 19 years, pocketing £29 million in the process. Not once during that time did they qualify their audit opinion on the financial statements, instead signing off the figures put in front of them by the company's directors. Yet, had KPMG been prepared to challenge management, the warning signs were there in highly questionable assumptions about construction contract revenue and the intangible asset of goodwill accumulated in historic acquisitions. These assumptions were fundamental to the picture of corporate health presented in audited annual accounts. In failing to exercise—and voice—professional scepticism towards Carillion's aggressive accounting judgements, KPMG was complicit in them. It should take its own share of responsibility for the consequences".[21]

IAS 1 and the IFRS system is based on a defective assumption regarding what transactions should be accounted for

The model the IASB has pursued of accounts to be 'decision useful' or 'useful for users' is flawed. Accounting should deal with transactions and contingencies of **the company** with the outside world such as customers and suppliers, and the suppliers of finance, including the shareholders.

Instead the IASB has pursued a model which supposes that a new form of information is needed to **displace** the traditional model (rather than

[21] https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/76906.htm#_idTextAnchor103

supplement it) in order to assist parties trading shares. However transactions between shareholders of shares are not transactions of the company. The IASB's model results in and depends on creating inter alia, artificial assets, and artificial liabilities, costs and income which doesn't actually assist in valuing shares either.

An example is the recently introduced IFRS 16 (leases). By that standard, companies with operating leases now have to account for leases as if they own the asset and as if they possess a capital liability. Furthermore, instead of the rental payment appearing in the profit and loss account under IFRS 16, the rental payment is eliminated to be replaced by an artificial number for 'depreciation' with an artificial 'interest' charge. The treatment is positively misleading as to the cash at stake as any reader of accounts would assume deprecation is a non-cash cost. Such artifices do not deliver the objective of 'predicting future cash flows' as they've misstated even the historic ones.

Indeed with the measure of EBITDA (earnings before interest, tax, depreciation and amortization) a measure some management prefer to use which is permitted under IAS 1, the cost of the rental payment in any form is entirely absent as the rental payment is transformed into interest and depreciation, which is excluded by EBITDA.

With the COVID crisis, the lack of soundness of the model of IFRS is clear with the IASB's consultation on accounting for rental waivers by landlords. IFRS 16 cannot deal with the fact that companies may be in forbearance and not paying the rent which IFRS 16 has transformed into an asset, liability, depreciation and interest. Furthermore, the IFRS 16 also gives the impression that the lessee has assets that can be liquidated to pay down debt when they can't.

Essentially the IASB is tripping itself up over its own model time and time again. We list just four examples.

- IAS 39 (bad debts and fair value was a contributor to the last banking crisis)
- IFRS 17 (the insurance standard) is not to be implemented
- IFRS 9 the replacement to IAS 39 took over 10 years to implement but is also flawed
- IFRS 16 (lease accounting) is already causing problems shortly after introduction.

Response to Questions on IAS 1

Question 1—operating profit or loss

Paragraph 60(a) of the Exposure Draft proposes that all entities present in the statement of profit or loss a subtotal for operating profit or loss.

Paragraph BC53 of the Basis for Conclusions describes the Board's reasons for this proposal.

Do you agree with the proposal? Why or why not? If not, what alternative approach would you suggest and why?

Answer:

LAPFF recommends the formats required by EU Directive and the UK Companies Act for the balance sheet as well as profit and loss account. Operating profit is a requirement for those formats. LAPFF notes that IFRS 16 in particular materially distorts operating profit as the rental cost (a cash cost) is removed and replaced by notional depreciation (a non-cash cost) and notional interest.

Question 2—the operating category

Paragraph 46 of the Exposure Draft proposes that entities classify in the operating category all income and expenses not classified in the other categories, such as the investing category or the financing category.

Paragraphs BC54–BC57 of the Basis for Conclusions describe the Board's reasons for this proposal.

Do you agree with this proposal? Why or why not? If not, what alternative approach would you suggest and why?

Answer:

LAPFF agrees that operating income should comprise all costs other than investing or financing. However, as set out above with the example of IFRS 16, a key operating cost, a rental payment, is turned into a financing cost and depreciation.

Question 3—the operating category: income and expenses from investments made in the course of an entity's main business activities

Paragraph 48 of the Exposure Draft proposes that an entity classifies in the operating category income and expenses from investments made in the course of the entity's main business activities.

Paragraphs BC58–BC61 of the Basis for Conclusions describe the Board's reasons for this proposal.

Do you agree with the proposal? Why or why not? If not, what alternative approach would you suggest and why?

Answer:

Agree with the proposal.

Question 4—the operating category: an entity that provides financing to customers as a main business activity

Paragraph 51 of the Exposure Draft proposes that an entity that provides financing to customers as a main business activity classify in the operating category either:

- income and expenses from financing activities, and from cash and cash equivalents, that relate to the provision of financing to customers; or
- all income and expenses from financing activities and all income and expenses from cash and cash equivalents.

Paragraphs BC62–BC69 of the Basis for Conclusions describe the Board's reasons for the proposals.

Do you agree with the proposal? Why or why not? If not, what alternative approach would you suggest and why?

Answer: Agree with the proposal.

Question 5—the investing category

Paragraphs 47–48 of the Exposure Draft propose that an entity classifies in the investing category income and expenses (including related incremental expenses) from assets that generate a return individually and largely independently of other resources held by the entity, unless they are investments made in the course of the entity's main business activities.

Paragraphs BC48–BC52 of the Basis for Conclusions describe the Board's reasons for the proposal.

Do you agree with the proposal? Why or why not? If not, what alternative approach would you suggest and why?

Answer: Agree with the proposal.

GENERAL PRESENTATION AND DISCLOSURES

Question 6—profit or loss before financing and income tax and the financing Category

Paragraphs 60(c) and 64 of the Exposure Draft propose that all entities, except for some specified entities (see paragraph 64 of the Exposure Draft), present a profit or loss before financing and income tax subtotal in the statement of profit or loss.

Paragraph 49 of the Exposure Draft proposes which income and expenses an entity classifies in the financing category.

Paragraphs BC33–BC45 of the Basis for Conclusions describe the Board's reasons for the proposals.

Do you agree with the proposals? Why or why not? If not, what alternative approach would you suggest and why?

Answer: Agree with the proposal as it's consistent with the statutory requirements. However, under IFRS 16 rental payments which are operating costs, are replaced by depreciation and notional interest (a financing cost). See answer to Q9.

Question 7—integral and non-integral associates and joint ventures

(a) The proposed new paragraphs 20A–20D of IFRS 12 would define 'integral associates and joint ventures' and 'non-integral associates and joint ventures'; and require an entity to identify them.

(b) Paragraph 60(b) of the Exposure Draft proposes to require that an entity present in the statement of profit or loss a subtotal for operating profit or loss and income and expenses from integral associates and joint ventures.

(c) Paragraphs 53, 75(a) and 82(g)–82(h) of the Exposure Draft, the proposed new paragraph 38A of IAS 7 and the proposed new paragraph 20E of IFRS 12 would require an entity to provide information about integral associates and joint ventures separately from non-integral associates and joint ventures.

Paragraphs BC77–BC89 and BC205–BC213 of the Basis for Conclusions describe the Board's reasons for these proposals and discuss approaches that were considered but rejected by the Board. Do you agree with the proposals? Why or why not? If not, what alternative approach would you suggest and why?

Answer: Agree with the proposal.

Question 8—roles of the primary financial statements and the notes, aggregation and disaggregation

Paragraphs 20–21 of the Exposure Draft set out the proposed description of the roles of the primary financial statements and the notes.

Paragraphs 25–28 and B5–B15 of the Exposure Draft set out proposals for principles and general requirements on the aggregation and disaggregation of information.

Paragraphs BC19–BC27 of the Basis for Conclusions describe the Board's reasons for these proposals. Do you agree with the proposals? Why or why not? If not, what alternative approach would you suggest and why?

Answer: As set out earlier, the roles described in para 20 are a limitation of scope. The test that accounts are robust enough for lawful distributions has created a clear responsibility for auditors which encompasses any misstatement whether fraud or error, or getting the going concern assumption wrong. However, elements of the auditing profession created the construct of an 'expectation gap' to deny that responsibility, which then requires denying that role of accounts.

Research evidence shows that the position of the IASB follows the model decided by elements of the accounting profession. Given that UK Parliamentary Committees were alert to regulatory capture in the context of the UK Financial Reporting Council it is not difficult to extend the analysis of the same problem to the International Accounting Standards Board. The problem is also contained in the constitution of the International Accounting Standards Board, which is under the control of the Trustees of the International Financial Reporting Standards (IFRS) Foundation. Article 2 (a) of the constitution states:-

"To develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions;"

Question 9—analysis of operating expenses

Paragraphs 68 and B45 of the Exposure Draft propose requirements and application guidance to help an entity to decide whether to present its operating expenses using the nature of expense method or the function of expense method of analysis. Paragraph 72 of the Exposure Draft proposes requiring an entity that provides an analysis of its operating expenses by function in the statement of profit or loss to provide an analysis using the nature of expense method in the notes.

Paragraphs BC109–BC114 of the Basis for Conclusions describe the Board's reasons for the proposals.

Do you agree with the proposals? Why or why not? If not, what alternative approach would you suggest and why?

Answer: LAPFF agrees that the function and nature of the expense are relevant. However, IFRS in creating hypothetical costs and income results in accounts that don't reflect the nature or function of an expense.

For example, with the treatment of IFRS 16 (leases) neither the nature nor the function of the rental expenses appears in the accounts.

The recently issued prospectus of Whitbread Plc shows that the introduction of IFRS 16 (page 3) caused operating profit for the year to 28 Feb 2019 to rise from £294.7m to £365.5m, and gross assets rising from £7,904.6m to £10,034m

Whitbread sets out how because of this bondholder covenants are assessed by eliminating the effects of IFRS 16. Given that the needs of bondholders are not met by IFRS 16 it's difficult to see how any shareholder or creditor would find the IFRS accounts relevant either.

Question 10—unusual income and expenses

Paragraph 100 of the Exposure Draft introduces a definition of 'unusual income and expenses'.

Paragraph 101 of the Exposure Draft proposes to require all entities to disclose unusual income and expenses in a single note.

Paragraphs B67–B75 of the Exposure Draft propose application guidance to help an entity to identify its unusual income and expenses.

Paragraphs 101(a)–101(d) of the Exposure Draft propose what information should be disclosed relating to unusual income and expenses.

Paragraphs BC122–BC144 of the Basis for Conclusions describe the Board's reasons for the proposals and discuss approaches that were considered but rejected by the Board.

Do you agree with the proposals? Why or why not? If not, what alternative approach would you suggest and why?

Answer: Unusual income and unusual expenses should be in separate notes.

Question 11—management performance measures

(a) Paragraph 103 of the Exposure Draft proposes a definition of 'management performance measures'.

(b) Paragraph 106 of the Exposure Draft proposes requiring an entity to disclose in a single note information about its management performance measures.

(c) Paragraphs 106(a)–106(d) of the Exposure Draft propose what information an entity would be required to disclose about its management performance measures.

Paragraphs BC145–BC180 of the Basis for Conclusions describe the Board's reasons for the proposals and discuss approaches that were considered but rejected by the Board.

Do you agree that information about management performance measures as defined by the Board should be included in the financial statements? Why or why not?

Do you agree with the proposed disclosure requirements for management performance measures? Why or why not? If not, what alternative disclosures would you suggest and why?

Answer: This appears to be an example of 'mission creep' by the board, the ways different parts of annual reports are audited is relevant as different objectives and reliability tests apply to different parts, as set out in the answer to Question 8.

The proposals to include 'management performance measures' in the accounts themselves risks confusing matters further due to the vague term 'useful information' being invoked. Different ways of doing this exist outside of the accounts sections of annual reports.

The purpose of accounts is to show the position of the company and its profits and losses, the performance of management will clearly contribute to that, but that should not be dealt with by accounting standards. Furthermore many IFRS treatments in accounts give a distorted view of the company. Adding management performance to that adds to the confusion.

Question 12—EBITDA

Paragraphs BC172–BC173 of the Basis for Conclusions explain why the Board has not proposed requirements relating to EBITDA.

Do you agree? Why or why not? If not, what alternative approach would you suggest and why?

Answer: EBITDA may be a feature of some analysis in that it adds back some costs, but that should not be done in the accounts.

Question 13—statement of cash flows

(a) The proposed amendment to paragraph 18(b) of IAS 7 would require operating profit or loss to be the starting point for the indirect method of reporting cash flows from operating activities.

(b) The proposed new paragraphs 33A and 34A–34D of IAS 7 would specify the classification of interest and dividend cash flows.

Paragraphs BC185–BC208 of the Basis for Conclusions describe the Board's reasons for the proposals and discusses approaches that were considered but rejected by the Board.

Do you agree with the proposals? Why or why not? If not, what alternative approach would you suggest and why?

Answer: IFRS 'indirect' method of preparing a cash flow statement doesn't actually reflect cash flows. For example, because the profit and loss account excludes sales or value added taxes, they do not appear in the cash flow. For some business, the upfront collection of taxes are significant cash flows.

A further problem is that IFRS is causing cash items to excluded from the profit and loss accounts and arbitrary non-cash items to be included.

Question 14—other comments

Do you have any other comments on the proposals in the Exposure Draft, including the analysis of the effects (paragraphs BC232–BC312 of the Basis for Conclusions, including Appendix) and Illustrative Examples accompanying the Exposure Draft?

Answer: As stated the IASB is running with the wrong model. The IFRS system has created a theoretical framework that isn't grounded in principles of business, investment or the legal frameworks underpinning accounts. Rather than dealing with problems, the IFRS system is haphazard and creating them.

Professor Marie Anne Frison Roche of Bordeaux University[22] describes the problem with IFRS not being rationally systematic.

"[IFRS is] an accumulation of intermittent standards that respond to specific problems – a process that will never result in a system. This is serious, because it makes it difficult to interpret the whole, thus rendering it unpredictable. It becomes deficient the moment a specific standard is not immediately, or even preventively, adopted in order to specifically resolve the problem, since the lack of a system means that general arguments are unavailable.

IAS 1 needs to be amended to:

- correct the mis-description of equity
- correct statements on going concern by removing conditions dependent on management assertions and setting out the actual conditions to being a going concern
- add the capital maintenance purpose of accounts
- add the accountability purpose of accounts
- add the proper definition of prudence as "booking foreseeable liabilities and likely losses, and no booking of unrealised profits"
- replace the word 'measurement' with 'cost or valuation'.

[22] ANC, Second Symposium on Accounting Research. Paris. 2012.

Local Authority Pension Fund Forum

Appendix A

Some examples of problems with IFRS and the effect on profits and net assets

Unrealised – non-cash profits – in the profit and loss account, giving a false impression of profit and cash generation (the absence of prudence)

Tax losses treated as assets, despite the fact that crystalising these losses is wholly contingent on profits of the future

Not capturing likely losses and foreseeable liabilities (because of the absence of prudence)

Cash rental payments treated as deprecation (which is a non-cash cost) and obscuring the cash which changes hands, and forms the real financial commitment. The accounts also by capitalizing leases give the impression that there is an asset which could pay down debt by being sold, "the right to sell". The IASB's concept of a "right to use asset, hence putting lease assets on balance sheet" gives a misleading impression of ownership without the flexibility that ownership carries with it.

As an observation there is a pattern of the IASB, setting unusual standards, on the basis of assertions, without taking account of second and third order implications, i.e. more rounded consequences. This was the case with 'incurred loss provisioning' where the faults were immediately obvious, this is also the case with 'right to use assets' which has clear faults in the context of leases (IFRS 16).

It is clear from the CFA Institute's recent comment letter on the emergency amendments to IFRS 16 because of the COVID crisis[23],that the relevant matter in a lease situation is the amount of rental commitments paid and to be paid annually.

Given that the going concern position of companies, indeed whole sectors in some cases, depends on the cash flow commitment on leases, the fact that IFRS leaves out the cash amount of rental payments, whilst at the same time making it appear that the company owns assets that a third party has title to is grossly misleading.

In short, IFRS 16 has created wholly misleading entries in accounts on the basis that the company is assumed to be a going concern; whilst the IFRS 16 accounting masks the 'real world' rental payments of a company which are relevant to whether it is a going concern or not

[23] http://eifrs.ifrs.org/eifrs/comment_letters//563/563_26519_SandyPetersCFAInstitute_0_RentConcessionCLIASB_Final_London.pdf