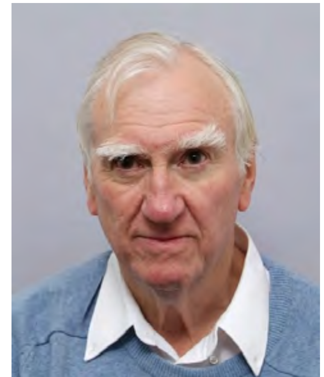
If we must have Brexit, can we have UK GAAP back, please?

by Malcolm Howard



In the January 2017 edition of TPI Peter Parry pointed out that with regard to 'banks' the IFRS accounting system is inadequate. He quoted a letter which included the following:

The fact is that bank accounts – drawn up according to IFRS accounting standards – showed "profit" and "capital" that overstated their true strength.

Well, the point is that IFRS is not an accounting system based on basic principles, but one drawn up based on financial economics. For thousands of years the basic principles associated with accounts were:

- accounts are prepared showing what actually happened (historical cost accounting).
- that for every debit, there must be a credit (the matching concept).
- that profits and assets must not be overstated and losses and liabilities must not be understated (the prudence concept).

Under IFRS all three of these basic principles have been abandoned. The first problem we have with this is that IFRS often overstates assets and understates liabilities and is therefore imprudent.

An example of such imprudence can be found in the accounts of Land Securities plc. On 3 November 2004 the company embarked on debt refinancing. It exchanged all outstanding bond and debenture debt for new medium term notes (MTNs) with a higher nominal value. It did this to reduce the interest rate paid, but, of course, to balance this out it had to increase its liabilities. The correct entry for this would be debit 'reserves on the equity side of the balance sheet' and credit 'creditors'. But the new MTNs did not meet IAS 39 requirements and accordingly the company could not show the increased debt in their books. Instead this increased debt is amortised, which is included in interest expense in the Income Statement. At 31 March 2016 this meant the Land Securities debt was understated by £368.3 million (will be slightly lower in 2017), which is a critical figure if you are valuing property companies on the basis of net asset value.

Under UK GAAP assets that had a current value in excess of historical cost would be revalued. The difference between such revaluation and historical cost would be debited to the asset and the associated credit would go to the equity side of the Balance Sheet, the exact opposite of what should have happened in the Land Securities case. But IFRS goes much further; the difference between revaluation and historical cost is taken as profit. It gets worse; revaluation under GAAP insisted upon a prudent valuation, but IFRS uses the concept of 'fair value'.

'Fair value' is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction. The estimation of fair value does not assume the asset is saleable at the reporting date, nor is it the amount that a company would receive in a forced transaction, involuntary liquidation or distressed sale. So if a company knew it had to sell an asset at a distressed price to reduce its debt, such an asset would go into the books at the full market value. Even if there was no market for a particular asset, 'fair value' would still have to be estimated.

Financial derivatives are also valued at 'fair value'. Like assets, this would be acceptable in isolation. What is wrong is taking unrealised profit in the income statement and although unrealised losses are also taken into account it all leads to greater volatility and uncertainty. Under UK GAAP, increases in valuation

were not taken into account, but a loss was taken in the income statement, where current value fell below historical cost. As 'fair value' is subjective, directors can effectively, within reason, choose what profit they want to declare.

Companies often spend a great deal of money in research to bring out new products. When they believe that their research is so advanced that they can actually produce a new product, the definition of research is reclassified as 'development'. Under IFRS, while research costs should be written off, development costs should be capitalised. Obviously, where development costs include marketing, companies have plenty of scope for imprudence.

Development costs, together with the excess of a price paid for taking over a company compared to the net asset value of that company (goodwill) are called 'intangible assets'. Under UK GAAP, intangible assets were written off over twenty years. Under IFRS, what is written off is down entirely to the judgement of the company directors. They are supposed to evaluate their intangible assets every year to determine their true value. This is, as you would expect, an almost impossible task, so quite often the decision is taken to do nothing. But IFRS does create some interesting discussions with regard to this method of accounting. For example, the value of intangibles is based on what is thought to be the future profits generated because of these assets. In their accounts for the year ended 31 December 2016, Carillion plc valued their 'Intangible assets' at £1.669 billion. But since then they have said that their 2016 profit was over £1 million lower than they previously thought. In other words, their intangible assets were generating a lot less profit than previously thought. It will be interesting to see what their valuation of intangibles will be in their 2017 accounts, due out in March 2018.

When the directors of the company declare a dividend, they state the amount to be paid, the ex-dividend date and the date the dividend will be paid. Under company law the dividend has to be ratified by shareholders at an AGM held prior to the ex-dividend date, but it is almost unheard of for shareholders to reject such dividend. Under UK GAAP the proposed dividend was charged to the income statement and credited to creditors. Under IFRS proposed dividends are ignored.

Where IFRS really do enter the realms of fantasy is the flawed concept of 'share based payments'. For example, the company might offer a director the option to buy 100,000 shares at £5 per share (the current market price in 2017) any time between 1 January 2022 and 31 December 2025. The company could go to their bank and ask to buy an option. The bank would weigh up the situation and would quote a figure. If they did that, then you would know the price of the option and the double entry would be debit 'options' credit 'cash'. In other words you have met the matching concept as you have a debit and a credit.

But companies do not buy an option, so do not incur any cost. If, for example, the company's share price in 2023 was £8 per share, the company would issue 100,000 shares for £5, if the director wished to take up his option. This would cause a minor dilution and the shares might fall back to £7.90, the price at which the director would sell his shares on the open market. In this transaction, the company has incurred no cost whatsoever; in fact is has benefitted from a cash injection of £500,000. Shareholders, as a body, have missed out slightly as the share price has fallen. But they are delighted; the director must have done a good job to get the price up in the first place.

But IFRS cannot understand this; remember, we have left accounting and have moved to financial economics. So the income statement has to be charged with a fictitious 'share based payment', often using the Black-Scholes model. This model assumes two things, neither of which holds true:

- Markets are perfect, every investor is equally knowledgeable and will act rationally.
- The historical volatility of a share is a good predictor of future volatility as it is constant.

So, having calculated an imaginary option cost to be charged to the Income Statement, what do we do with the corresponding liability? Well, we cannot do anything because there isn't a liability. What this means is that the equity side of the balance sheet remains the same regardless of whether a share based payment is charged or not. Now, where the share price falls and the option is therefore valueless, the income statement is still charged with a share based payment. Of course, the accounting firms charge for calculating the cost of share options, which reduces the amount of profit (and cash for that matter) which is available for shareholders. Shareholders are paying dearly for irrelevant information.

Taking all the above into account it can be seen that the income statement no longer shows what actually happened, but is simply a conglomeration of judgements, none of which shareholders can assess or challenge. Only the cash flow statement can be trusted these days.

So can we have UK GAAP back, please, modified to incorporate the one benefit that IFRS gave us - which is that net assets or liabilities in company pension schemes are included in the accounts?

Letter to the Editor

From Peter Bartram

Dear Editor,

I do feel impelled to congratulate you on John Hunter's piece in your latest Newsletter. Quite apart from the injustice of it, I feel that the Tories' failure to take effective action on the issue of top people's pay is adding significantly to social division and Corbyn's perceived legitimacy.

When working in the UK at the HQ of a major multinational corporation in the 80s, I was a member of its Remuneration Committee and could see how the ratchet effect worked, with comparisons always being made with the highest paid execs in competitor organisations. There was no countervailing restraint on the process. And since then it has got astronomically worse.

I do hope that your words on this issue will be heeded properly, and soon. Otherwise we really will have to look forward to Prime Minister Corbyn.

Independent Financial Advisors – how unbiased are they?

by Peter Parry

I find the rules surrounding pensions baffling. I have always used a financial advisor for my pension and been handsomely ripped-off for doing so. In one case this involved a trip to the Financial Ombudsman Service. I won, but that is another story.

For a number of reasons I decided in June 2016 to look for a new IFA. One of the routes I tried was to go to a website called 'unbiased.co.uk'. None of the firms listed took commissions (which are now outlawed anyway) but in many cases their charging structure was simply based on a percentage of funds under management. Underneath the veneer of simplicity and clarity it was opaque. I wanted more transparency. I wanted to know what I was getting and what it was costing. Essentially, I wanted a menu of services, an ability to pick the ones I needed when I needed them and then pay for them on an hourly basis. I spoke to about six firms in total, none of which offered what I really wanted.