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Restore prudence as overriding principle

Sir, The European Commission will shortly opine on whether it feels our accounting system for publicly listed companies — IFRS — has served the EU well.

It is our view that there are serious shortcomings. The good news is that there are solutions that would be relatively straightforward to implement.

Most importantly, prudence should be restored as the overriding accounting principle so that capital and performance are not overstated. The breakdown of realised and unrealised income should be visible to all.

These changes are not just vital for effective stewardship by executives, directors and shareholders; they are necessary to bring the accounting framework back into line with existing legal requirements for capital protection as originally set out in the EU's second directive.

Evidence of problems with our accounting system is not hard to find. Whether it is hidden capital weakness in European banks (perhaps continuing today), directors paying out illegal dividends based on faulty accounts at Betfair plc, or the accounting games exposed at Tesco in September, it should be clear that — the audit problem aside — something has gone wrong with company accounts.

We believe the problem lies with the move in the EU to an accounting system (IFRS) that prioritises "neutrality" ("the absence from bias") over prudence.

Prudence ensures that performance and capital are not overstated. This in turn underpins the confidence of shareholders and lenders in companies' balance sheet strength and capital stewardship.

Without prudence, IFRS have relied more heavily on mark-to-market (MTM) to value assets and performance. With IFRS it is not possible to be certain as to what profits have been realised as cash, or what the capital position really is. This might seem like an esoteric point, but has far-reaching impacts for the public interest.

Most obviously, MTM gains on trading assets at banks fed an exaggerated view of profits and capital before the financial crisis. This in turn helped to fuel an excessively risky lending boom.

Ordinary people across Europe continue to count the cost of this period of over-optimism in the form of lower living standards.

It is a fallacy to suppose that accounts merely provide a window on to the real world. They also shape reality by influencing behaviour. And the damage is not limited to the financial sector, as highlighted by issues at Tesco. While aggressive accounting will be a problem with any set of standards (and requires robustly independent audit), the lack of prudence permitted by IFRS fuels uncertainty over what has actually been earned. This can, in turn, lead to inappropriate strategic and operational decisions.

The failures of our accounting framework need to be openly examined, and we welcome the Commission's ongoing review. The accounting system remains one of the key unaddressed faultlines behind the financial crisis. The public deserves action.

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