The law of opposites: Illusory profits in the financial sector [1]

Written by **Blog Editor** [2] | Wednesday 14 December 2011

An Adam Smith Institute report released today (Wednesday) claims that the failings of the International Financial Reporting Standards (IFRS) allows banks to overstate their profits by recognising years of often very uncertain future income as current profit. As well as having the potential to deceive investors and lead to misallocations of capital, this overstatement of profits benefits company executives whose performance is typically measured and rewarded on this basis. Recent developments in accounting rules have encouraged, rather than tried to prevent this. In addition, the latest developments of the Basel international rules specifying banks capital and liquidity minima only exacerbate the problem.

Though standardised accounting standards effect many sectors, any unintended consequences they throw up are especially problematic for banks, since such failures are magnified by banks taking exposure to each other. Moreover, in the case of banks attracting state bailouts, real transparency is clearly needed to protect the taxpayer.

The Adam Smith Institute report is structured around six shortcomings in the rules governing bank profit and capital reporting, which must be addressed:

- Uncertain future cashflows can be recognised as certain by purchasing a credit default swap (CDS) or similar ?protection?, even though the supplier of the protection is likely to default if the insured event occurs;
- Profits can be recognised from the increased value of assets, or decreased value of liabilities, on the basis of a market price, even though the totality of revalued assets or liabilities could not be sold at that price;
- Profits can be recognised from the increased value of assets, or decreased value of liabilities, even when the revaluation of assets is estimated, not by market prices, but by a model built by bank employees. This is the so-called mark-to-model approach to valuation;
- The net present value of uncertain future cashflows can be recognised as profits even when they are estimated using implausibly optimistic forecasts. (This is a variation of the mark-to-model problem listed above);
- The EU?s IFRS accounting system, voluntarily adopted by UK and Irish banks at the banking company level, is inconsistent with UK law
- Banks need not make provision for expected losses when calculating their profit.

With much of the activity in the banking sector aimed at nothing more than exploiting these accounting rules, the report suggests the introduction Steve Baker MP?s bill to bring about simple legislation to reveal the extent of mark-to-market and mark-to-model banking activity.

Author Gordon Kerr adds: ?Accurate accounting is at the root of the legal and scrutiny framework; without accurate accounts basic laws are incapable of enforcement. As this report shows, banks have been using loopholes in these rules to inflate their accounts and create illusory profits, which pay for bonuses and short-term gains for their shareholders, but give a very misleading view of their real financial health.

"The accounting regulation system needs radical reform so that banks are not encouraged by the rules and regulations to invest in risky assets to make themselves seem more profitable than they really are. Honest balance sheets are the cornerstone of a healthy financial system ? right now, we don't have the transparency we desperately need to avoid a repeat of 2008.?

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