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Melt down at the IASB?

In an astonishing volte-face, the IASB has had to bow to political pressure and abandon both a key tenet of IAS 39 and its own due process. From 1 July IFRS reporters are able to re-classify 'held for trading' financial instruments to 'held to maturity' and avoid further fair value measurement.

If asked before this week, most people would say that the fastest you could amend an IFRS would be something like a year, but with two years more likely. The IASB set a new record by amending IAS 39 inside ten days, although quite a lot pf other things got broken in the process.

On 4th October, a meeting of EU Finance Ministers (in Paris, of course) issued a document dealing with the credit crisis and saying that they would 'ensure that European financial institutions were not disadvantaged vis-à-vis their international competitors in terms of accounting rules and their interpretation'. The ministers said banks should be able to re-classify out of fair value through profit and loss, and if the IASB did not deal with it by the end of October, they would ask the European Commission to issue its own rules.

Later that week, the Trustees of the IASC Foundation, coincidentally having a scheduled meeting, agreed that due process could be suspended. Gavin Francis, the IASB's Director of Capital Markets, spent the weekend reviewing US GAAP and drafting an amendment to IAS 39 and IFRS 7, and Monday lunchtime, the IASB in an extraordinary session voted through the amendments not only for immediate issue but for application from 1 July 2008. The amendment was issued later that afternoon.

Sir David Tweedie told Board members: 'There are calls for a level playing field, partly because of misunderstandings, but these have got a lot of traction. Either the politicians are going to do it, or we do it. It might open the floodgates. We have very little time. I know that nobody wants to do this.'

Former FASB member Jim Leisenring said that US GAAP had been misrepresented to European politicians. John Smith, formerly Deloitte's financial instruments specialist in New York and now an IASB member, said that although US GAAP allowed securities to be re-classified, this was only permitted under 'rare' circumstances and nobody did it. The IASB's proposal would not result in a level playing field.

Nonetheless, the IASB passed the amendments 11-2, with Leisenring and Smith dissenting. Board members stressed that this was a temporary measure, to deal with an emergency.

IFRS companies will be able to re-classify mortgage securities (this is permitted under SFAS 65) and other financial securities in ‘rare’ circumstances. Sir David Tweedie’s comments accompanying the issue of the amendments specifically referred to ‘the rare circumstances of the credit crisis’.
To continue the unlikely chain of events, the European Financial Reporting Advisory Group (EFRAG) also abandoned its due process and issued positive endorsement advice to the European Commission on the next day.

Conspiracy theorists will be happy to learn that apparently President Sarkozy commissioned a report on the financial crisis from an accountant, René Ricol, a former president of IFAC etc. etc. Ricol produced a report saying that American banks were able to re-classify financial instruments and why could French banks not do so. Sarkozy took this up with the finance ministers and the communiqué I cited was the result.

However, it seems that people thought there was no way that the IASB could come up with any changes because of its due process requirements (which was the reason for the 31 October deadline) and started to draft a new carve-out to IAS 39 to submit to the EU Accounting Regulatory Committee (which is formally the body that endorses IFRS into EU law). The ARC was due to meet towards the end of October.

The IASB learned of this and, given the coincidence that the Trustees were meeting (albeit in Beijing), asked last week for permission to ignore due process. They received it and scheduled a Wednesday slot in this week’s IASB public meetings. Then the ARC meeting was brought forward to this Wednesday morning (someone having heard of the IASB’s tactic), so the IASB advanced its discussion to Monday, and lined up EFRAG to issue their advice on Tuesday (supposedly done by conference call at 7am Tuesday morning). The ARC met Wednesday morning (15 October) and endorsed the IASB amendment, which was then approved by the European Parliament.

However, that is by far from the end of the story. The IASB refused to let people reclassify instruments they were accounting for at fair value through profit and loss where they were doing this under the fair value option. Their argument: the option is only available to people who manage their financial instruments on a fair value basis or to correct can accounting mismatch, so why would they change? (The not very hidden agenda: the European Central Bank forced the IASB to modify the option and restrict its use in this way. The Europeans can live with the consequences.)

Apparently, although the ARC agreed the IASB amendment, it is to hold another meeting next week to consider whether there is a need for a carve-out on top of that, and to consider the standard-setting arrangements. People close to the process say that if there were to be another carve-out, that would signal the end of the IASB. There would be European GAAP as well as IFRS, and of course, that is precisely what some people would like.

Has the IASB been broken by European political pressure? It is of course too early to say. Its independence and credibility have been damaged, and the banking lobby has once again demonstrated its political clout. The SEC is supposedly very unhappy about the IASB’s amendment. Politically this is saying that EU finance ministers can write IFRS, and that would be a potent argument in the US against replacing US GAAP with IFRS. Conceivably the 2011 adopters, Canada, India, Japan, China, Korea and Brazil could decide that IFRS were tainted too.

The most extreme case scenario would be that worldwide convergence on IFRS is rolled back. But this is unlikely to happen, in that there is strong political will for convergence and the IASB is the beneficiary at the moment. There is no current alternative. The FASB survived political disasters in both the 1970s (oil and gas) and 1990s (stock options) and still survives.

However, this event provides a basis of an argument for creating a successor body. It also provides an encouragement to industry lobby groups to go for political lobbying and not bother with talking to the standard-setter. That may make it impossible for the IASB to work effectively, but we will not know that for some years yet. At least they can enjoy the irony of European Finance Ministers insisting that US GAAP be applied by European companies.

I do not think the upcoming ARC meeting will lead to another carve out – it would need about 19 out of 27 votes in favour. However, if there was a decision to launch a European standard-setter, that could even strengthen the IASB, because European interference has been the biggest obstacle to its success so far.

A footnote: analysts point out that it is far too late the change investor perceptions about the banks' investments and management performance.

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