Opening Submission to the Banking Inquiry

John McDonnell

Introduction

I was invited to appear before the Committee as part of a panel with Mr. Ronan Murphy (Senior Partner of PricewaterhouseCoopers Ireland ("PwC")) in my capacity as relevant Bank Audit partner in relation to Bank of Ireland. I was the Lead Audit Partner to Bank of Ireland from 2010 to 2014. I am a Partner in the banking and capital markets group within our Firm and have worked extensively with Irish and international banks and financial institutions during my 31 year career with PwC.

There have been three PwC Lead Audit Partners to Bank of Ireland since 2001, the other two of whom have retired from the Firm. Whilst not directly involved in the Bank of Ireland audits between 2001 and 2009, I am familiar with the audit procedures adopted by PwC in the audit of banks in the period in question.

I became a partner in PwC in 2000 and have been the Lead Audit Partner on many of the Firm's largest public company audits in both financial services and nonfinancial services. I am a partner in PwC's Global Accounting Consulting Services Group with provides IFRS accounting advice to partners and staff within our Global Firm and to clients. In this role, I was the leader of the PwC Ireland's Accounting Consulting Services Group from 2005 to 2010. I specialise in accounting for financial instruments under International Financial Reporting Standards ("IFRS") including impairment.

I chair the IFRS impairment group of our Global Firm and led our Global Firm's responses to the International Accounting Standards Board ("IASB") expected loss proposals for accounting for loan impairment now included in IFRS 9 Financial Instruments ("IFRS 9"). I am also a member of the IASB's Transition Resource Group for Impairment of Financial Instruments which analyses and discusses stakeholder issues arising from implementation of the new impairment rules of IFRS 9. I was also a member of the UK Accounting Standards Board Urgent Issues Task Force which issued interpretations on UK Accounting Standards.

I am also the Chairman of the Governance Board of PwC.

Context of my appearance

In advance of my appearance, the Committee provided me with a direction to address aspects of the remit of the Inquiry as they impact the statutory audit process. The direction set out the themes which it wishes me to cover. These are

- Integrity of financial reporting
- Appropriateness of property-related lending strategies and risk appetite
- The liquidity versus solvency debate
- Adequacy of the assessment and communication of both solvency and liquidity risks in the banking institutions and sector

- Capital structure and loss absorption capacity
- Impact of prevailing accounting standards in recognising risks
- Effectiveness of the external audit processes to identify and report to the board and management, any concerns related to significant risk exposures, including property, funding and liquidity.

Consistent with Mr. Murphy, my evidence on these themes relates to the work performed by PwC in our role as statutory auditor.

Mr. Murphy was directed to address the first five of the themes. As I have read and agree with the content of Mr. Murphy's Opening Submission, to avoid repetition, I propose to address only the last two themes in my submission.

Impact of prevailing accounting standards in recognising risks

The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity. Accounting standards set the rules for the preparation of financial statements and these rules address recognition and measurement. IFRS are the accounting standards that applied to listed entities in Ireland including banks from 2005.

Financial statements portray the effects of past transactions or events. They are not intended to provide all the information that users may need to make economic decisions. The aim of accounting standards is to ***faithfully represent*** past transactions or events in financial statements. Matters such as stability and capital adequacy are outside the remit of accounting standards.

When preparing a set of financial statements a preparer first considers whether it is acceptable to recognise an asset, liability or transaction under the rules of IFRS. If recognition is appropriate then the preparer considers how one should measure this asset, liability or transaction. It is important to understand the interaction of recognition and measurement when one considers how financial statements are made up. Recognition always comes first. If the recognition rules of IFRS are not met then there is nothing to measure and measurement rules are not relevant.

The requirement to focus on past transactions and events means that IFRS addresses risk through measurement only. In fact, IFRS prohibits the recognition of future events. By way of example:

1) There is a general rule in International Accounting Standard ("IAS") 39 Financial Instruments: Recognition and Measurement that losses expected as a result of future events, no matter how likely, are not recognised as impairment on loans and receivables ***- the incurred loss approach***

2) There is a general rule in IAS37 Provisions, Contingent Liabilities and Contingent Assets that provisions should not be recognised for future operating losses
3) IAS10 Events after the Reporting Period does not allow an entity to recognise the financial impact of events that arise after the balance sheet date concerning conditions that did not exist at the balance sheet date.

IFRS only recognises past transactions and not future events or risks.

Once an asset or liability (including an incurred loss in the context of impairment) is recognised, under the rules of IFRS, it needs to be measured. The measurement requirements of IFRS do take account of risk, but risk is measured differently depending on the measurement approach adopted.

IFRS has two measurement approaches - fair value and amortised cost. Cost is the primary measurement approach with fair value being optional or required in specified circumstances (for example, financial instruments held for trading). Most financial assets and liabilities are required to be accounted for at amortised cost including loans and receivables.

If an asset or liability is measured at fair value, this value will take account of the market's assessment of the risk of the expected cash flows at the balance sheet date. The expected cash flows take account of the coupon or interest rate (including credit spread) of the financial instrument and if this coupon adequately compensates the holder for the expected credit losses then a fair value loss will not arise. Where expected credit losses exceed the amount compensated for in the coupon, then a fair value loss will arise.

Fair value is a point in time assessment and it is important to note that changes in this assessment post balance sheet are not reflected in the balance sheet fair value. By way of example, a major fall in asset prices, as was seen in the crisis, between the balance sheet date and the date the financial statements are signed is not reflected in the balance sheet measurement as this fall does not reflect the market's expectations at the balance sheet date.

In contrast, amortised cost does not reflect the variability in the value of an asset or liability to the same extent as fair value. By way of example, IFRS does not require entities to determine different outcomes and probability weight these scenarios (expected value) in the measurement of incurred losses for impairment. Impairment losses are typically calculated using a best estimate approach (single most likely outcome) which does not take account of the impact of worse case situations. One cannot, under IFRS, provide based on the worse case outcome only.

While there is no shared understanding among users, preparers and regulators of what the term prudence means, many would advance that prudent accounting would include the following:-

a) a conservative bias in recognition and measurement;
b) different recognition thresholds for assets and liabilities with a lower threshold for the recognition of a liability than for an asset;
c) the need for greater evidence regarding the existence of assets and income than for liabilities and expenses;
d) losses recognised as early as possible; and
e) unrealised gains not being recognised.

IFRS does not include such prudence or conservatism as a part of faithful representation because including either of these assessments would be inconsistent with its required objective of ***neutrality***. Therefore, it is not possible under IFRS to create general provisions for losses or to provide based on worst case outcomes. In fact, we saw the release of general loan loss provisions in banks across Europe when they moved their accounting basis to IFRS in 2005.

As Mr. Murphy noted in his Opening Submission, this approach to recognition and measurement led to an ***expectation gap*** between reported losses and a user's expectation of the ultimate cash loss. As a result of this and other concerns, IFRS has been strongly criticised in the aftermath of the financial crisis. In particular the following criticisms have been made:-

a) fair value accounting made the crisis worse
b) the incurred loss model for impairment is not fit for purpose and caused the recognition of loan losses " too little too late".

The IASB have tackled some of these criticisms with an overhaul of financial instruments accounting. However, fair value accounting remains and, under the new accounting standard for financial instruments, IFRS 9, many financial assets and financial liabilities will have to be accounted for at fair value going forward.

One of the main changes in IFRS 9 is a conceptual shift in the recognition of loan impairments with a move from the incurred loss model to an expected loss model. It took a very long time to develop this expected loss model. The implementation date for IFRS 9 is 2018, ten years after the start of the crisis.

IFRS set the rules which had to be applied in the financial statements of Irish banks during the financial crisis. The financial crisis tested some of these rules and found them wanting. Changes have now been made. But, nonetheless, they were the prevailing rules and notwithstanding one's view of their fitness for purpose, they were required to be applied***. The accounting rules of the time did not allow the recognition of future events or risks.***

Effectiveness of the external audit processes to identify and report to the board and management, any concerns related to significant risk exposures, including property, funding and liquidity.

The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework (IFRS in the case of Irish banks from 2005). The phrases used to express the auditor's opinion are "give a true and fair view" or "present fairly, in all material respects," which are equivalent terms.

Although the auditor's opinion enhances the credibility of the financial statements, the user cannot assume that the audit opinion is an assurance as to the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity.

In other words, the primary purpose of an audit is to provide independent assurance to shareholders that the directors have prepared the financial statements properly in accordance with the rules of IFRS. ***An audit does not exist to provide general comment or opinion on a company's business model.***

The auditor should obtain an understanding of the entity's objectives and strategies, and the related business risks that may result in material misstatement of the financial statements. They do this through detailed discussions with the board and management while bringing their own perspectives and experiences to bear.

As Mr. Murphy set out in his Opening Submission there is a clear delineation of responsibilities between board and management as preparers and approvers of financial statements and the Statutory Auditor in their capacity as auditor of these statements. In this regard, it is the responsibility of the board and management to set banks risk appetite, risk management framework, internal control, and risk and other reporting framework (both internal and external). Auditing standards require auditors consider these in the context of the risks of material misstatement in the financial statements, design their audit tests to address these risks and report the outcome of this work to those charged with governance. Mr. Murphy set out in his Opening Submission our communication of risks in this context within the banks.

Mr. Murphy has noted in his Opening Submission the subsequent responses to the financial crisis and enhancement to the audit process under the heading International Dimension and subsequent improvements. Auditing standards have been enhanced, post crisis, with increased requirements for communication with those charged with governance.

The appropriate balance between the responsibilities of the board and management and the responsibility of auditors was considered by the Financial Reporting Council ("FRC") post crisis. The FRC noted that it is a fundamental tenet of company law that a company's management, not its auditors, are responsible for the management of that company, including the use to which its assets are put, the liabilities that it incurs and effectiveness of its internal controls. For that reason, the FRC believe that the responsibility for disclosing information about a company rests with the company rather than the auditor.

It is on this basis that the FRC changed the Corporate Governance Code for Irish and UK listed entities. As a result, the corporate governance disclosures were enhanced in 2013 with requirements for boards to state whether their annual report and financial statements, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the entity's performance, business model and strategy. Audit committees have a central role in this assessment. Audit committees are also now required to disclose in their report the significant accounting issues considered in their review of the financial statements.

These changes also impact the reporting by auditors with the audit report for Irish listed entities being considerably expanded. Auditors are now required to report on the new audit committee and board statements noted in the previous paragraph and to explain their audit scope, materiality and areas of audit focus and how they addressed those areas.

These are part of a series of enhancements to try to bridge the expectation gap and to set out more clearly the respective responsibilities of the board, management and the auditors and how they interact in the audit process.

Conclusion

IFRS set the rules which had to be applied in financial statements of Irish banks during the financial crisis. The accounting rules at the time did not allow the recognition of future events or risks. The primary purpose of an audit is to provide independent assurance to shareholders that the directors have prepared the financial statements properly in accordance with the rules of IFRS.

We support the changes made to accounting, auditing and corporate governance standards discussed above. We welcome the opportunity to continue to engage with the various stakeholders in the overall debate on improving financial reporting.