Bank auditing

The dogs that didn't bark

Historically, banks and insurance firms were tightly disciplined by governments but auditing rules became more lax and thus, very few spotted the onset of our banking fiasco, writes William Kingston.

One of the unresolved questions about the banking debacle relates to the role of the banks' auditors. Light has now been thrown on this by a joint administrator of Quinn Insurances, Michael McAteer, in his comment on the firm's year-end figures. These showed a trading loss of €127.5m, but also a €677.6m extraordinary charge. This charge reflects guarantees for other firms in the Quinn group which had not been acceptable to the insurance regulator, resulting in administration for that side of the business.

"Because of the guarantees, we could not include those assets in the regulatory return but those assets are not gone," Mr. McAteer said. "If we were doing returns for the Companies' Office, those assets would still be there." The returns which the Companies' Office receives, of course, are those which the law requires auditors to prepare for the shareholders of any limited company.

In these, it is obvious to any lay person that assets which could be called in on foot of guarantees are not the same as assets which are unencumbered. They may not be gone but equally, they might go. For example, Quinn has argued vehemently that these particular guarantees had no effect at all on the value of the assets, whereas the Regulator ruled that they destroyed the ability of these assets to contribute to the level of solvency required for safe writing of insurance policies.

Audited accounts should provide an unambiguous basis for sound decisions, not just by shareholders but also by others who deal with a business including the Government and creditors. If an asset has a contingent liability attached to it, auditors record the existence of both, without judging how far the value of the asset is impaired by the liability. They do this in light of standards and guidelines laid down by their professional institutions, and it is now clear that these are too low, as the Quinn example shows, than those required by the new insurance Regulator.

Indeed, they are lower than common sense would require, and the public is now paying a terrible price for their application to banks' accounts.

How could such a situation have come about? For this, we can look to a recent letter to the UK Department of Business by Tim Bush on mistakes of the Accounting Standards Board (ASB) in London, "of such severity that it is difficult to overstate it". The ASB has jurisdiction in this country as well as in the UK, and Bush asked for his letter to be sent on to the Irish Government.

As a member of the ASB's own Urgent Issues Task Force, he claims that "a shared model that had worked in the UK and Ireland since 1879 was replaced by another shared one that produced false profits and overstated capital, misleading shareholders, the Bank of England, the Financial Services Authority and others".

The significance of the year 1879 is that it was then that banks were first granted limited liability. Before that, public policy was careful to ensure that dealers in money were liable up to the limit of their personal fortunes for any debts. In fact, the first specific legislation for this in the world was that of the Dublin parliament in 1721. Another world first of the same parliament, allowing for partnerships with limited liability, in 1782 explicitly excluded bankers from the privilege. Even when general limited liability came to these islands in 1855, it did not apply to banks for another 24 years.

As long as the liability of those who dealt in money was unlimited, they were naturally careful about the risks they took. In fact, the failure of the City of Glasgow Bank in 1878 (which triggered the Banking Act of the following year) shows how strict this discipline was. No depositor nor note-holder lost a penny but only 254 of the 1819 shareholders were able to avoid bankruptcy.

The 1879 Act imposed a requirement for the auditing of firms to protect their shareholders and creditors, and around the turn of that century, those who performed this function were able to persuade the government that they themselves should regulate it. This led to the quasi-legislative standard-setting of the ASB.

Bush points out that one of these standards (AS 39) positively subverted the legal requirement that accounts should reflect a firm's solvency, by requiring that only losses actually incurred have to be recorded, without any estimation of what future losses might be. This, he holds, was a factor in the collapse of three major banks.

As he says: "Not alone are accounts using AS39 unreliable for making distributions of dividends and paying tax, but they are also unreliable for paying employees, in fact even lending, as the accounts may be showing false profits in what may already be an insolvent bank, or a bank heading towards insolvency which should not be lending at all."

He goes on to add that the standards applied to banks "eliminated the rules and formats that for Companies Act accounts are fixed into the law" because those who drew them up had been heavily influenced by the Securities and Exchange Commission of the United States. This body "is not an investigator of the abuse of limited liability status: these are actually creditor protection and stewardship problems. Basically, banks overstated the values of their assets and overtraded on that".

The world is now learning for a second time through bitter experience (the first time was in 1929) just how great a mistake it was to allow bankers escape from the discipline of unlimited liability. It was a similar mistake to allow auditors to establish their own operating standards since they will inevitably set these too low, in order to please the clients who pay them. Some new way must be found to finance auditing, since capitalism can only work to the extent that capitalists are denied the power to decide their own working conditions.

We should be grateful to McAteer, therefore, for unwittingly contributing to an answer to Queen Elizabeth's question about the banking crisis, "why had no one spotted it coming?"

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