

THOUGHT  
OF THE DAY

'Certainly no politics are more real than those of academic life, no loves deeper, no hatreds more burning, no principles more sacred'

ISAIAH BERLIN (philosopher, 1909-1997), from a letter to Freya Stark, 12 June 1944

# Bank reform will never work unless you tackle the accountants



Nicholas Jones

THE MAIN parties have all now pronounced on the tangled topic of banking reform. Their proposals will, we're told, ensure that the financial crisis - now two years old - never happens again. They certainly describe in detail who will be in charge of what. But why have both the opposition plans, and the Government's recent White Paper on bank regulation, glossed over the critical subject of accounting reform? Without it, the door is simply left open for a replay of the crisis.

The bean-counters who keep the books in any financial business know that accountancy is the key to running it properly. Unfortunately, the directors and traders of our fabled City institutions know it is also the key to running it improperly - and to sluicing its shareholders' funds into their own pockets through incentive schemes.

The bonus mania which caused the recession could never have happened without corrupted accounting rules. This is the great secret of the credit crunch - the one the world's financial writers have missed. But without resolving the issue of duff accounting, I'm afraid our politicians' proposals are rather pointless.

The scandal of how banks and insurance companies account for financial instruments - the credit default swaps etc - hit me by chance. After completing a film about the inventor of the jet engine, I decided to pursue another British science success story - the mathematicians who develop the financial products that give the City its global edge.

A past in accountancy soon made me realise their complex trading models must require expert auditing, so investors could see where their money was going. When bank shares crashed, it of course evaporated. Yet the accountancy giants auditing the banks had given them a clean bill of health.

Auditors are paid to warn shareholders of deception in a company's accounts, so how did they fail to spot the banks were going bust? The regulators, ministers and White Paper have been somewhat reluctant to ask. Cormac Butler, author of *Accounting For Financial Instruments*, is almost a lone City voice who did. His scholarly findings provide a warning to be very wary of the annual report.

The lust for bonuses led bank directors and traders to pressure their auditors to stretch the accountancy rules wherever possible, to inflate profits. Hence bonuses are often based on profits calculated through accountancy that just doesn't add up. Of course, you might think the financial debacle would make now the perfect time

to reform accounting practices. Life isn't that simple.

Accounts staff who daily input debits and credits through the ledgers would be mystified if they knew what those at the peak of their profession can legally do. To learn how the latter work is to enter a Byzantine world of terms such as cherry-picking, off-balance sheet, day one profits and mark-to-market

Cherry-picking is a form of accounting that fools the innocent. Imagine a bank's trader buys five financial instruments at £1,000 each. At year-end, four have dropped in value to £200 each - but the fifth is now worth £1,300. Clearly he has lost £2,900 (£300 profit less £3,200 loss). By abusing the accounting rules, the bank can leave the four loss-making trades on the books at £1,000 each - and then cash in the fifth at £1,300. The bank thus claims its £5,000 invested has made a £300 profit - from which a bonus duly flows.

All company accounts contain a balance sheet - a page listing assets (cash, debtors, stocks) less liabilities. A principle cause of the credit crunch is a practice known

## Bonus mania could not have happened without corrupted accounting rules

as off-balance-sheet accounting. Banks use this to keep loss-making investments off the balance sheet in their annual reports, thereby boosting profits. Given the scale, this has vastly increased apparent profits, enabled bonuses and concealed the true state of affairs from shareholders and regulators.

Mark-to-market is no less complex but I mention it because it shows why accountancy reform is unlikely to happen. It requires banks to value deteriorating assets at a market price. It sounds reasonable - except to the titans of finance. In April, US accountancy rules were relaxed to enable banks to sidestep mark-to-market and so boost their profits. Lobbyists are now pressuring Europe's accounting regulators to follow suit. The next target is a planned rule to curtail off-balance-sheet accounting.

The auditing firms can live with poor banking accountancy, for their prosperity comes from building relationships with the banks who pay their fees. Nursing huge losses, private shareholders see things differently: the UK Shareholders Association is now planning a campaign for tighter accounting rules. In the battle for our politicians' ears, both the White Paper and the opposition's rival plans suggest that the banking and accounting lobbies are the only ones who get heard.

The writer is creative director of Quanta Films

# Sporting glories are the ultimate human drama



Brian Viner

ALL SPORTS have their detractors, as does sport as a generic whole, but it is hard to think of any more maligned than cricket and golf. The late Robert Morley

enjoying the Centre Court action even though Roger Federer had every chance of getting out alive, but there we go, golf will continue to be dogged by the hackneyed charge that it requires no obvious feats of athleticism or stamina.

And those who don't understand the glory of Test cricket will continue to snipe at it for what they consider to be its frailties, but what in fact are theirs. "I have always looked on cricket as

Flintoff falling on one crooked knee and spreading his arms messianically wide after taking five Australian wickets to all but clinch the second Ashes Test for England ... that wasn't just sport, that was human drama at its most richly compelling.

And yet there is an argument that neither Watson nor Flintoff can legitimately be described as heroes, that if a person who dives into a river to save a drowning

lovely story against himself, that having invoked the Battle of Stalingrad in his description of an epic sporting occasion he was telephoned by the then-deputy sports editor, who calmly pointed out that 150,000 people died at the Battle of Stalingrad and gently suggested an alternative choice of imagery.

Plainly, sportsmen and women should always be lionised with a certain sense of perspective, which is what the great Australian

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