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Financial Instrument Accounting - Speech by Sir Andrew Large to the 13th Central Banking Conference in London

The recent furore over IAS 39 - the international accounting standard for financial instruments - has resulted in a situation which all agree is unsatisfactory, Sir Andrew Large, Deputy Governor of the Bank of England, says today in a speech to a central banking conference in London. There are now effectively two versions of IAS 39, one proposed by the International Accounting Standards Board and the other by the European Commission. Sir Andrew says: "In my view, the only way forward is first to take a few steps back, before work starts on re-engineering the standard."

There should be a re-examination of the basics, aimed at securing agreement on fundamental principles. "These could be stated as clear principles in a preamble and it might enable the widely held vision of a less detailed and prescriptive standard to be realised, to replace the hundreds of pages of complex rules."

Sir Andrew says that meaningful accounting standards and their effective implementation are highly relevant to any central bank's responsibilities for financial stability because they help to ensure the safe and efficient functioning of the financial system. "So it is essential that accounting standards have a clear economic rationale, promote comparability and secure adequate disclosure. Only in that way can investors, creditors and others judge the positions and risks being run by financial institutions and hence exert market discipline, and perverse incentives be avoided."

But despite intensive work to improve accounting standards for financial instruments in recent years, fundamental issues with financial stability implications remain to be resolved. One crucial question he tackles in the speech is: 'Who and what are accounts for?' Another more specific issue is the appropriate role of fair value accounting.

On the first question, he says different users of accounts may, at least to an extent, want information produced on different bases. "And the simple fact is that we will not be able to make progress if different users all assert that their way of calculating or presenting the numbers is uniquely correct."

"I suggest, therefore, that the users of accounts should recognise that they may in reality need to adjust them to suit their particular purposes - something ratings agencies and other analysts have done for many years. It is encouraging that the Basel Committee on Banking Supervision has adopted precisely that approach in promulgating various adjustments for regulatory purposes to data based on IAS 39. Against that background, it would seem helpful if accounting standard setters required supplementary disclosures in published accounts which would allow different users to make such adjustments."

Turning to fair value accounting, he says recent experience in the UK and the US has been encouraging. But he emphasises the importance of avoiding rules which introduce spurious volatility, of which hedge accounting under IAS 39 can be an example. The sheer complexity of the hedge accounting rules is an issue and "we need to ensure that the rules themselves do not result in perverse behaviour as people try to find a way round them."

In taking a few steps back before re-engineering the IAS 39 standard, it is sensible first to reach a consensus on the fundamental issues, including who and what the accounts are for, where the standard should be placed along the spectrum between historic costs and fair value measurement and the implications of any increase in volatility of accounting results. This should be done before moving to detailed drafting of a new IAS 39, Sir Andrew says.

Other issues to consider include whether there should be a gradual transition or a big bang introduction of the new standard and also whether public sector interests are adequately represented in the procedures for setting accounting standards. He was sure the Trustees of the IASB would be reflecting on the latter point in their consideration of the organisation's future governance.

Key Resources

Financial Instrument Accounting - Full Speech

<http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2004/speech231.pdf>