

Accounting rules did not overstate losses – but t...

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The [FT has noted](#):

Accounting rules probably understated, not overstated, the losses embedded in the financial system, according to a report on Tuesday from an influential group of policymakers. The report concludes, controversially, that the rules did not add to the pro-cyclical nature of the financial system.

It is widely assumed that the practice of marking assets to market prices and not reserving for expected losses on loan portfolios added to the woes of the financial system by deepening losses at a point when banks and other institutions could least afford it.

However, the report by the Financial Crisis Advisory Group concludes that because in most countries the majority of bank assets are not marked to market, but kept at their historic value, those values probably underestimated the losses now being exposed by the crisis.

I am going to be generous for a moment and assume the person who wrote this report was not an accountant. But if they were they'd realise what complete rubbish this is.

First, it follows that if losses were understated then profits were overstated. The result is obvious: the accounts were misstated. The exuberance of the reported profit did not match the underlying reality. In that case drastic revision in expectation gave rise to the crash in the market. Is that to be sold to us as a success?

Second, to say historic cost gave rise to this overstatement is absurd. The bank accounting SORP (Statement of Recommended Practice) does not allow for that in most cases. When assets are held for resale in a portfolio mark to market is encouraged under that SORP if I recall it correctly i.e. losses must be anticipated (but profits are not). This need not be applied (again if I recall correctly) if the holding is material to the market as a whole and therefore likely to distort market price if sold. Of course this would be true of some bank assets — but not all, by any means, and even then there is in historic cost accounting the true and fair over-ride that losses are anticipated. The whole model is built on the premise that losses are taken when anticipated and profits

are deferred until realised. By design profit is therefore understated.

The exact reverse is true of International Financial Reporting Standards. These are designed to anticipate profit by marking to market but to defer anticipation of any loss not currently priced by the market. As such they are always inclined to overstate profit. That is the inherent design flaw in the system — and it is precisely this requirement that losses not be anticipated that has brought down Bradford and Bingley, Cattle plc and others. They did not anticipate very obvious losses because IFRS said they did not need to as they had not been realised — which is the only time IFRS recognises losses as arising — and so their balance sheets were, to put it bluntly, misstated, but were true and fair within IFRS rules — which is absurd.

In other words — this report is a complete whitewash and argues the very reverse of what is true — whilst dressing up over-statement of profit giving rise to systematic mis-statement of bank accounts as a virtue. Hardly a matter to shout about, I'd have thought.