Funding the Future

Some fundamental accounting might do no harm

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I suggested yesterday that the failures in auditing at PWC might be systemic, even though (inevitably) the Financial Reporting Council did not test that hypothesis.

Today I want to go a little further and suggest that the failure in accounting is systemic. My suggestion is that accountancy has been complicit in the valuation of things that simply do not exist.

One of the accusations against PWC was that they had signed off accounts which stated assets to have worth which was simply not in existence. So, an investment was stated to be worth more than £200 million when in fact it was worth, at most, £1. There were other examples. But the issue is not specific to BHS and the companies associated with it. The problem is systemic.

Accountancy is riddled with intangible assets. And arbitrary valuations. I'm not seeking to get too technical here. What I am referring to are four basic categories of assets. Being more specific does not help the argument.

The first such asset is goodwill. This is the excess value paid when acquiring a business over the sum that can be attributed to tangible, physical assets that can be valued in their own right.

The second group of assets are legally constructed property rights. These are things like patents and copyrights that only have value by presuming there is a future income stream.

The third are those supposedly marketable assets that apparently generate an income but for which there is no current market and to which a value is attributed on a 'mark to market' basis using models that might be as accurate as a forecast that it will snow in the UK today.

And finally are assets created intra-group. These are investments, loans and liabilities created in an intense web of transactions that are in themselves likely to be largely commercially meaningless but which leave a trail of interdependencies that render the accounts that include them largely incomprehensible in themselves, but which are nonetheless declared to be true and fair.

You can argue there are more or fewer such groupings. You can discuss which is more or less esoteric. I have problems with them whichever way you address the issue. The problems are, essentially, twofold.

The first is that these assets may simply not exist. Indeed, in isolation, they do not. So, goodwill is not independent of the underlying entity; intra-group debt is only of worth if the whole group might be, but not even then necessarily, and copyright only has worth as long as the property it relates to is still seen, heard or read. So the fact that someone once paid for these things is proof of nothing more than potential misjudgement at some time in the past. Too often that is now proving to be true. Not always, I stress. But too often. Which suggests that unquestioning acceptance of valuations based on pure history or models is failing accountancy.

And second? The problem is in the income statement. We recognise income from these assets in many cases (intra-group debt often excepted). But when we do we do not apparently think it appropriate to recognise that in most cases we bought that income. In other words, goodwill simply represents a purchased income stream. And an acquired copyright had a cost to buying the future income. And I think it should be mandatory that the cost in question be written off against the income. In fact, it should be written off even when there is no or little income. But accountancy is far too lax on this now, albeit it once was not.

Accounts are riddled, in my opinion, with assets that do not exist because they are at best nothing more than purchased income streams whose cost should have been written off against that revenue. Or the assets are simply manufactured.

I am not suggesting there is never a reason to recognise these assets. There may be, albeit with an over-riding requirement of prudent valuation that is now entirely absent from accounting. But, and this is key, investors need to be vastly more aware of their existence so that they can appraise the risk in an entity. So too do auditors need to do that because, simple souls that they seem to be, they are apparently quite unable to appraise this risk at present even when it hits them in the face.

The need is for a test of resilience. That is, a measure of the durability of the company when all these assets are stripped from consideration. That’s a second balance sheet in effect. The directors would, of course, be wholly at liberty to say why they thought this misrepresented the position of the company: I would have no difficulty with that, as long as they were personally liable for their claims. And then the investor can decide. Do they want the accounting hubris, or not? Some fundamental accounting might do no harm.