Funding the Future

International Financial Reporting Standards should be c...

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Hans Hoogervorst, the chair of the International Financial Reporting Standards Foundation, has written in the FT this morning arguing that:

[Some critics of accounting standards now] want to require banks to make upfront provisions for all expected lifetime losses on loans and, presumably, a return to good old historical cost accounting, which values assets at the price they were initially purchased. Though superficially appealing, these changes would weaken prudent accounting, rather than strengthen it.

He proceeds to justify existing accounting standards on this basis, not least by claiming:

Critics also allege that IFRS has been too enamoured of fair value accounting. In fact, banks value almost all of their loan portfolios at cost, so the historical cost method remains much more pervasive.

There are a number of important things to note about this article, none of which are flattering to Mr Hoogervorst.

First, the issue he notes is only an example of the criticism I and others have made of the IFRS Foundation and its accounting standards. Our concerns are much more fundamental than he represents and he should know it. If he does not then he is even worse at his job than I thought. These criticisms actually focus on the fact that IFRS do not produce information of use to anyone. That's because they do not tell investors whether or not the returns that they supposedly enjoy are actually payable by the companies in question, or are in fact fraudulent, as has too often been the case. Nor do they indicate the company's resilience, and for the long-term investor that is critical. Nor do they provide information on how the company uses its resources. So, for example, country-by-country reporting is completely absent from current accounting requirements, because the IFRS Foundation has completely ignored it, and yet this is a key indication of how the company has acted as best steward of the funds entrusted to it. Despite this the IFRS Foundation claim that investors do not need this data. I could go on, but the point is fundamental. The IFRS Foundation claim that the only users of the financial data produced by their standards are investors, and yet they fail even that group of accounting data users. It's a pretty damning indictment.

Second, there is no public interest justification for the IFRS Foundation's choice to restrict their interest to those of investors: this is not what company law requires, and it is not what their public duty requires. It has, instead, been adopted to suit companies and auditors. In practice, it means that the IFRS Foundation is not only failing in its public duty, and so should have its public funding withdrawn; it also means that it deliberately ensures that all other users of financial statements (from regulators, including those of banks, to tax authorities, to the public, to employees, to customers, and suppliers; let alone civil society) have no useful information on which to form their opinions. The IFRS Foundation say they must simply rely on the data that investors require, but that is absurd because they do not have interests in common and nor do they have the means to secure that information in any other way. In other words, the IFRS Foundation has made it its job to promote accounting opacity.

Third, and for me most tellingly, the article is wrong. Of course most bank loan portfolios are valued at cost. What else would you value them at? They are assets, and very few people choose to repay more than they are lent, in which case cost is the maximum value at which they might be stated in most accounts. The problem is not the fact that the loans are stated at cost. The problem is that they should not be stated at less than cost because provisioning is entirely possible. And Mr Hoogervorst is also wrong in his claim, made in the article, that loan provisioning cannot take place from the day on which advances are made. Given that it is known that a certain percentage of all advances will fail, even if specific detail is not known, general provisions against loans should always be made from the moment that a sum is advanced. Accounts do not relate to specific transactions in this sense: they represent a statement of portfolio risk, and since that risk is inherent in any portfolio the provision must take place. Mr Hoogervorst is being disingenuous to claim otherwise. Or maybe he simply does not understand what he's talking about?

I am delighted that the chair of the IFRS Foundation thinks it appropriate to answer his critics. I'm shocked that he does so quite so ineptly. It suggests that not only should the role of the big four as the sole auditors of large companies come to an end, but that their chosen accounting standards, biased as they are solely to the interests of those firms, should also be consigned to history.