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Bring back Prudence

We should eschew monopoly in accounting and allow alternative sets of standards to compete, argue Stella Fearnley and Shyam Sunder

By Accountancy editorial

Fairness is a judgment not a description; in our discussion of valuation in financial reporting we set aside the rhetorically loaded 'fair' value in favour of the neutral 'current' value. The 'fair' label discourages discourse by implying that its critics favour 'unfair' accounting.

Discussions of fair value accounting have focused on two issues: the decision usefulness and stewardship functions of accounting. We discuss both and show that current valuation is no better than other valuation methods in serving either of these two goals; in some respects it is worse. It may also undermine the reliability of the audit opinion.

The usefulness of current values for making investment decisions is a simple and straightforward statistical argument: if a company's resources are valued more accurately, decisions based on more accurate data would be better. Since value of resources tends to change over time, historical numbers associated with resource acquisition transactions tend to become obsolete with the passage of time, thus creating price movement inaccuracies. Other things being equal, current values should provide more accurate data and therefore be a better basis for making investment decisions.

Other things are not equal

However, other things are not equal. Current values of some resources can be determined with precision, especially if they are standardised, and traded in liquid markets. Steel girders, food grains, automobiles and treasury bonds are examples of such resources. Financial reports based on current prices of such liquid resources (adjusted for their small transaction costs) serve the decision-making function well. The case for current value accounting is based on such resources.

If all resources belonged to this 'liquid' class, the decision-usefulness argument for current values would be quite reasonable. Unfortunately, this is not so in most companies, industries, or the economy as a whole. Most resources are not so liquid, and their current values are subject to estimation or guesswork that introduces varying degrees of inaccuracy in the current numbers thus creating price measurement errors.

Whether current values are more useful for making decisions depends on relative magnitudes of the two kinds of errors: movement errors arising from ignoring the changing prices; and measurement errors arising from the imperfections in the markets from which current values are determined. Price instability (for example, inflation, demand or technological change) contributes to movement errors while market imperfections contribute to measurement errors.

When movement errors are large relative to measurement errors, current values are better for decision-making; when the reverse is true, the use of current values results in worse decisions.

The full version of this feature is in the October issue of *Accountancy*

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