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Fair value accounting and the present value fallacy: The need for an alternative conceptual framework

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Abstract

The major functions of company accounting identified by the IASB and the FASB are (1) reporting on 'the custody and safekeeping' of the company's resources and (2) reporting on 'their efficient and profitable use'. The joint IASB/FASB project for improving the conceptual framework for financial reporting is directed towards better performance of both functions within the conventional 'accrual' system of accounting through the use of 'fair value'. Although the disclosure of fair values is a development to be welcomed, the requirement that *changes* in fair value should be reported as 'gains' or 'losses' appears to rely on the 'Hicksian' concept of income as a theoretical ideal.

The object of the present paper is to establish that this concept is fundamentally flawed by what may be called the 'present value fallacy'. Even in an economic utopia of perfectly competitive markets (with no discrepancies between objective market values and subjective present values), the concept of income or profit as value growth can be seriously misleading.

If the prevailing Hicksian conceptual framework is discarded in favour of an alternative based on Fisher's theory of income, the two major, but incompatible, functions of financial reporting can be carried out independently and without compromise. The conventional 'hybrid' system of accrual accounting, in which backward-looking measures of volume and forward-looking measures of value are mixed together, would be replaced by a 'segregated' system in which they are kept strictly apart. A logical extension of Fisher's theory suggests the disclosure by agent/managers of the return on investment that they are planning to deliver to their principal/owners. This type of 'decision-useful information' is vital for the efficient operation of capital markets and for removing the accounting incentive to short-termism.

Keywords: Fair value; Present value fallacy; Conceptual framework, Segregation of funds and value; Income theory

> Fisher's theory of income [is], by far, the best that has appeared in the literature. … It suggests more that could usefully be consciously adopted by accountants than does the writing of any other economist. (Canning, *The Economics of Accountancy*, 1929, p. 145)

1. Corporate governance, 'agency', and the free-market solution

The possibility of conflict of interest between agents and principals in company management has long been recognised:

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> The directors of such companies … being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. (Smith, 1776, vol. 1, P. 233)

It is difficult for one set of individuals—*however altruistic*—to make decisions in the economic interests of another set of individuals whose (often conflicting) preferences and opportunities they have no means of knowing:

> What cannot be known cannot be planned. (Hayek, 1988, p. 85)

If the notion of the central planner who can act in the best interests of every consumer is 'the fatal conceit' of socialism, the notion of the company director as an 'agent' who can act in the best interests of every investor can be said to be 'the fatal conceit' of managerial capitalism.

Nevertheless, the belief that this can be achieved by regulation remains strong:

> A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole. (Companies Act 2006, Section 172)

> All directors must take decisions objectively in the interests of the company. (Financial Reporting Council, 2006, p. 3)

Though the sentiment is admirable, it is an unenforceable aspiration—not unlike that of Article 11 of the old Soviet Constitution:

> The economic life of the USSR is determined and guided by the state economic plan for the purpose of increasing the wealth of society as a whole. (Supreme Soviet of the USSR, 1962, p. 15)

There is, however, an alternative to regulation which has proved remarkably successful. It is the solution proposed by Adam Smith. Free competition automatically aligns conflicting economic interests, even if each individual 'intends only his own gain':

> He is … led by an invisible hand to promote an end which was no part of his intention … By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. (1776, vol. 1, p. 421)

With the essential proviso that competition is genuine and free, self-interest can be harnessed in the service of 'the society':

> It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages. (1776, vol. 1, p. 16)

It is significant that the market system serves the economic interests of consumers even though the butcher, the brewer, and the baker are not hired as legal agents. *With effective market forces, agency is not necessary. Without effective market forces, agency is not sufficient*.

But market forces cannot be effective unless customers have sufficient information about the goods and services on offer to enable them to look after their own interests:

> The investor, too, can be expected to look after his own interests, provided that management, instead of attempting to maximize satisfaction for him, provides sufficient information to enable him to do so for himself. The 'invisible hand', insofar as it is effective, relies on information rather than altruism. (Rayman, 1972, p. 20)

The FASB and IASB, however, seem determined to ignore Smith's free-market solution to the agency problem. Instead, they are persisting with a conceptual framework based on a fallacy.