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The Decision Usefulness of Fair Value Accounting – A Theoretical Perspective

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ABSTR

Regulato nd the IASB argue th otably on the relev rtain non-financial ue with the notion o theoretical pers of the argume ysis is conduct ulness are adopted rspective. Findings be justified from bot ion aggrega ue measurement turns out to be theoretically restricted in its validity and applicability.

Also, comparative analysis of fair value accounting vs. historical cost accounting yields mixed results. One immediate implication of the research – a condition for the further implementation of fair value accounting – is the need to clarify standard setters' notion of accounting income, its presumed contribution to decision relevance and its disaggregation.

Acknowledgements

I am indebted to Christoph Kuhner for his critical and insightful comments at various stages of this project. Also, the helpful suggestions of two anonymous reviewers and the journal's previous editor, Kari Lukka are gratefully acknowledged. Finally, participation in the European Accounting Association's 2002 doctoral colloquium provided useful comments at a very early stage of this project, and lent valuable stimulus to my research.

Notes

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para. 8.

[4] Thomas S. Kuhn in his ‘Structure of Scientific Revolutions’ extensively discusses this term in the context of scientific methodology and develops his influential theory of the process and drivers of paradigm shifts. While Kuhn's ideas have been subject to contentious debate, with himself backtracking on the definition, the general idea of a paradigm as a set of shared beliefs appears useful for tentatively conceptualizing the theoretical basis of fair value measurement.

[5] The implementation of the decision usefulness objective drew from the Trueblood Report. However, the foundations had been developed much earlier both in the academic and the standard setting sphere. Significant contributions involve the AAA's ASOBAT and APB Statement No. 4. For an historical overview see Hendriksen and van Breda (1991, pp. 92–115, 126–131).

[6] See also SFAS 115, para. 40; SFAS 107, para. 39; SFAS 133, para. 220; and SFAS 157, para. C32. For similar conjectures in IASB pronouncements, see, for example, IAS 36, para. BCZ11; IAS 40, para. 40, B36; IASC (1997, ch. 5, paras. 2.6–2.12); and, more recently and broadly in the context of initial recognition, IASB (2005, paras. 99, 101–104).

[7] See SFAC No. 7, especially the section on ‘Present Value and Fair Value’ (paras. 25–38), and the observations on the evolution and implementation of the fair value paradigm in the following Section 2.3.

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[11]See Robinson (1991, p. 110). For the respective definitions, see SFAC No. 6, paras. 25–43, 70, 78–89; IASB Framework, paras. 53–64, 70 (Nobes, 2001, p. 9). The validity and necessity of the asset-liability approach as 'conceptual anchor' has only recently been reaffirmed by the SEC (SEC, 2003, p. 10).

[12]Former FASB member Arthur Wyatt refers to it as 'possibly the most significant initiative in accounting principles development in over 50 years' (Wyatt, 1991, p. 80), a notion emphasized by the testimony of SEC General Counsel James Doty to the US Senate, who made it clear that 'the time has run out on "once-upon-a-time-accounting"'.

[13]A similar reasoning can be found in the IASB's 2005 Discussion Paper on Measurement Bases, which emphasizes that the relevance of fair value as a measurement attribute for initial recognition stems from its 'market value properties', which are assumed to hold in principle for any fair value, that is, prevail irrespective of its estimation. See IASB (2005, paras. 111, 227–231).

[14]For instance, market valuation of long-lived non-financial assets was well established in the USA prior to the Great Crash and the ensuing security market regulation in the 1930s (Walker, 1992, pp. 4–8). Although the SEC later prohibited such practice, the issue of market value accounting for certain items was discussed regularly in the USA as well as in other countries (Wyatt, 1991; Christie, 1992, p. 97).

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[18]Thus, we do not subscribe to the implications of the impossibility result (Demski, 1973): the denial of the usefulness of applying conceptual criteria on the grounds of the specifity of individual decision contexts employs a Paretian notion of economic efficiency which is not adequate for economic analysis. Rather, economic analysis requires an assessment of the welfare implications of different alternatives which can only be properly evaluated on the basis of Kaldor–Hicks efficiency. While Pareto efficiency prescribes that no user will suffer a reduction in welfare from a new accounting regulation and at least one user will experience an increase in personal welfare, Kaldor–Hicks efficiency is less restrictive in that it requires an increase in aggregate welfare, that is, it implies that those users better off can compensate those users that suffer decreases in welfare. See Posner (1998, p. 16); in the context of normative evaluation of accounting alternatives Beaver and Demski (1974, p. 174), Cushing (1977, p. 311) and Ohlson (1987, pp. 2, 6).

[19]It is not the aim of this paper to give a thorough discussion on the merits of normative vs. positive research approaches. Based on the arguments given, it is simply assumed that there is a case for a priori reasoning, especially with respect to standard setting questions. For a more general discussion, see Cushing (1977), Christenson (1983), and Watts and Zimmerman (1990). For an assessment of potential standard setting implications of empirical research, especially value-relevance research, see Holthausen and Watts (2001).

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[22]The (re-)emergence of the EBO model can therefore be seen as a ‘renaissance’ of the measurement perspective (Beattie, 2002, p. 109).

[23]For the distinction between economic income in a narrow sense and this ‘economic profit’ see Christensen and Demski (2003, pp. 40, 50).

[24]Although, as pointed out, the frameworks elaborate no concept of informative earnings, several paragraphs hint at the notion of persistent earnings. See, for example, SFAC 1, para. 44; SFAC 5, para. 31; IASB Framework, paras. 28, 72–80.

[25]These results are turned upside down for residual income. Fair value residual income is constant in time and reflects the competitive advantage, that is, the fraction of sales that is earned on top of market expectations. Transaction-based residual income, on the other hand, increases in time and thus appears less indicative of the competitive advantage.

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