

# What's wrong with fair value accounting?

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Keep in mind

*"Recorded revenue was accepted as valid only on the basis of the objective evidence furnished by bona fide sales to independent parties"*

(Paton, W.A. and A.C. Littleton. American Accounting Association, 1940)

## Prelude

As the first step in this paper there is a need to demonstrate the evolution from a focus on the logic of bookkeeping to the point where we no longer discuss these issues but instead focus on valuation and the way calculated values are to be presented to the market place. The development of these trends has been both bureaucratic and politicized in which the struggle for power sometimes obscures other important issues. Earlier the problem was **what** the company had (the balance sheet) and **why** (the income statement), that is double entry bookkeeping and the flow of money was the focus. From bookkeeping to accounting it could be argued the 1900s was the era of regulation and the U.S. has taken command in order that accounting should be "owned" by a single stakeholder, investors. The first step in the regulation was to stop the use of market values in the balance sheet which had been in use before the stock market crash in 1929. The final step in this power struggle over accounting regulation in the U.S. came because of the expressed theory that high stock prices would contribute to an overall more positive perception of the economic situation and thereby contribute to increased consumption.<sup>1</sup> High share prices had been viewed as "keeping the wheels rolling" reflecting a perceived connection between subjective accounting in companies for the "general good". Values were more important than money for the regulation of society. As a result of this change in the relationship of accounting values and economic prosperity, it is important to discuss what value is and have an even a deeper discussion on the accounting relationship between cash and accruals and further discuss the development of the concept of accrual-based net income (sometimes called "anticipated income" when translated from other languages, e.g. Swedish). This essay does not focus on rules or regulations; the aim is only to increase the understanding of accounting. In this case, an essential aspect of the accrual accounting is that it contributes to a fusion of "what" and "why" and the income statement shows corrections of the unrealistic forecasts made in previous years. The balance sheet thus is the central report but may be unrealistic with respect to future cash flows. About the same time the opinion emerged that the role of accounting should be to provide the stock market with relevant information, stock market research accelerated and value relevance studies became a research area. After 1965, more than 1,000 academic research articles on the relationship between accounting measures and stock prices have been produced. Basically these studies are about whether the stock market reacts to the information provided by companies to the market and whether the reactions are strong or weak with respect to different kinds of information. In the long term, these reactions are collected to represent accumulated events for the so-called correlation studies. It has then been shown that short-term correlation was weaker than long-term correlation. These correlations, of course depend on expectations the market has for information given to it.<sup>2</sup> It might often be the case that an improved result in the company leads to falling share price because the market is expecting an even better result. A worse result could conceivably contribute to an increase in share price because the market expected a worse result. In the long term, however, share price performance moves in the same direction as the company's accounts describe. Low correlation in the short term thus does not need to be an indication of low value relevance.

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<sup>1</sup> Bengtsson, Bengt, *Redovisning i ett utvecklingsperspektiv – Från fakta till förhoppningar*, The Journal of the Economic Society of Finland, 2013:1

<sup>2</sup> Bengtsson, Bengt. *Redovisningens värde relevans i svenska fastighetsbolag före och efter införandet av IAS 40*, Åbo Akademi University Press, 2008