Bring Back Conservatism

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Fair value measurement and other accounting standards seek to reflect the real world and ensure equity across generations of investors. However, in the process, they have eroded the age-old principle of conservatism and resulted in volatile and, in some cases, unrealistic financial statements.

When studying accountancy in the 1970s, I was taught that "conservatism" was an immutable principle of accounting. This resonated with what my parents had taught me as a child about financial prudence, and saving for a rainy day.

In accounting, conservatism means that when there is uncertainty, expenses and liabilities should be recognised as soon as possible; and revenues and assets only when they are assured of being received.

Conservatism, also known as "prudence", has led to accounting practices such as the "lower of cost or market" rule for valuing inventory, and making provisions for all liabilities, expenses and losses – certain or uncertain in nature.

Today, the principle is still found in accounting literature. In the US-based Generally Accepted Accounting Principles (GAAP), it is one of 10 key accounting principles and guidelines, alongside "going concern", "full disclosure", "matching" and "materiality".

However, the slew of changes to accounting standards over the last two decades have diluted conservatism so much that it has effectively been thrown out of the window.

Indeed, the two major international standard-setting organisations, the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB), have stated that "neutrality of accounting" is preferred to "prudence". The IASB dropped prudence from its Conceptual Framework in 2010.

Fair value

The first major assault on conservatism was the push for "mark-to-market" valuations and fair value accounting in the early 2000s. These concepts are now entrenched in several accounting standards.

In brief, fair value is defined as the "price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market".

Fair value is a noble ideal that is meant to reflect market reality and ensure parity across generations of shareholders. For example, it is argued that stating an asset at historical cost when its market value has risen is unfair to an existing shareholder who has to sell his shares.

However, fair value creates its own problems.

First is the unnecessary volatility in the reporting of profit and loss. Take a bond that is held to maturity. Under historical cost accounting, the income recognised would simply be the stable recurring amount from the coupon payment. But when the bond is marked-to-market, the fluctuations of the bond value in the intervening accounting periods must be reflected in the holder's income statement.

The second and greater concern is the variable way in which fair value can be determined. The accounting profession now spends an inordinate amount of time creating, debating, amending and continually refining the accounting standards on fair value determination. FRS 113 (Fair Value Measurement) provides several generic approaches, while other standards cover specific areas such as biological assets (FRS 41), investment properties (FRS 40) and financial instruments (FRS 109).

FRS 113 provides a three-level framework based upon whether the "inputs" to the measurement process are:

1. observable (e.g. unadjusted market price of a listed stock)
2. indirectly observable (e.g. property value based on transactions of comparable properties), and
3. unobservable and thus based on assumptions by management.

Level 3 and even Level 2 valuations are, by their very nature, fraught with uncertainty and judgement. The use of assumptions and estimates provides a great deal of latitude and flexibility for companies to decide on the end numbers. A management team which is incorrectly incentivised to deliver short-term results can stretch its assumptions to produce a set of unrealistic financial reports.

Warren Buffet famously warned that "mark-to-market" accounting could easily become "mark-to-model" in illiquid markets, and even "mark-to-myth".

In recent years, several companies, notably Olam and Noble, have been publicly challenged by research firms and activists about the fair values in their respective balance sheets. Their defence was that they complied with the prevailing accounting standards and their financial statements were passed by the auditors. However, the market reactions and subsequent firms' actions lent some credence to the challenges.

Debt provisions

The latest onslaught on conservatism has come in the form of FRS 109. Effective since 1 January 2018, the standard fundamentally changes the way in which provisions are booked for financial assets such as receivables and loan books of banks.

Under the previous incurred loss approach, allowances for doubtful debts were of two types: general and specific. FRS 109 replaced this with a three-stage expected credit loss (ECL) impairment approach.

The main difference in outcomes between the two approaches is that ECL is procyclical while incurred loss can be countercyclical. In the traditional approach, the flexibility in making general provisions allowed for keeping more money aside for a rainy day during good times, and which could then be released in bad times. ECL limits the provisions that can be made in good times and increases the provisions needed in bad times when the horizon is darker, thus accentuating the impact on the profit and loss between good and bad times.

Conserve conservatism

Historically, financial statements were easy to understand. The number of rapidly changing accounting standards, especially the implementation of fair value accounting, have made financial statements today highly judgmental, and difficult to understand for investors, directors and even accountants themselves.

The accounting profession owes it to investors and those charged with governance to bring comprehension back to financial reporting, starting with conservatism as a driving principle. ■