Comments on deprival value and standard setting in measurement: from a symposium to celebrate the work of Professor William T. Baxter

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1. Editorial introduction
In July 2006 the London School of Economics (LSE) hosted a Symposium to celebrate the work of Professor William T. Baxter. The influence and continuing significance of Baxter’s work was discussed by experts from a range of academic and practitioner perspectives on the nature, relevance and usefulness of the concept of deprival value, with some views on the direction to be taken in setting measurement standards. In introducing their views, each speaker paid particular tribute to Baxter and then discussed a personal perception of the influence of his work. This summary of their presentations is offered as a comment on, and celebration of, the relevance of Baxter’s work in the expectation that the various perspectives will provide useful ideas for those whose research relates to the current debates on measurement and standard setting in accounting.

The comments begin with three retrospective analyses. Sir Ian Byatt, past Director General of the Office of Water Services, spoke on deprival value and its use in the utilities. Peter Holgate, senior technical partner at PricewaterhouseCoopers, reviewed the uses of deprival value in previous periods when inflation accounting was higher on the agenda. Professor Michael Bromwich, of the Department of Accounting and Finance at the London School of Economics, noted Baxter’s central role in the sequence of very active development of theories of accounting measurement. With a focus on the present, Professor Shyam Sunder of Yale University reflected on Baxter’s perception of the role of accounting standards. Dr Joanne Horton, senior lecturer in the Department of Accounting and Finance at the London School of Economics, outlined continuing debates on deprival value and relief value. Professor Ken Peasnell of Lancaster University reviewed the position of deprival value today. Professor Richard Macve of the London School of Economics drew the discussion to a close. The editor is grateful to an anonymous reviewer for suggestions on presenting this series of comments.

2. Sir Ian Byatt: deprival value and its use in the utilities
William Baxter established the principle of deprival value in modern day accounting. I will illustrate its use in nationalised and privatised utilities in the UK. I will show how it was critical to setting an initial regulatory capital value.

When setting out the principles for asset valuation, Baxter argued that the basis selected should bear in mind ‘the nature of the assets or liabilities concerned and the circumstances involved’. My task today is to talk about how my colleagues and I, working in the utility field (mainly as regulators or quasi-regulators) have applied, and tried to apply, these principles. My most recent example comes from my work this week. On Monday, I was a member of a three-man expert panel advising a national utility regulator. A key task was to advise on the regulatory capital value of the publicly owned electricity company. So far, the various parties have got into analytic complications that are generating a great deal of heat. Our task is to find a way ahead that can enable the parties to move in a systematic way to price control decisions that would cover the next six years. I believe that Baxter’s work on deprival value will help us in this task. All three of us are economists and found ourselves in discussion with a chartered accountant; I am glad to be able to tell you that I successfully disarmed him by referring to Baxter and his work.

The story of my involvement with deprival value goes back a long way – to the days when I was working in the Treasury on matters concerning nationalised industries. (The Government did not, of
course, regulate nationalised industries, it sponsored them, but the Treasury at least tried to maintain some kind of financial discipline.) This financial discipline was constantly subject to stress, for a variety of day-to-day reasons, some connected with ministerial activity or inactivity, and some concerned with the behaviour of the industries themselves. In 1961, in 1967 and again in 1976, the Treasury took major steps to embed better discipline in the system of control. In 1961, the government established a system of financial targets, to ensure five-year break even on Revenue Account, supplementary depreciation to cover inflationary erosion of historical cost accounting deprecation and a current contribution to future capital investment. But the issues of a rate of return on all assets and their capital value were not addressed. In 1967 economics ruled, with the use of discounted cash flow investment appraisal and marginal cost pricing. Accounting costs were to be covered, but nowhere was there any discussion of what that might mean.

In 1976, the Treasury moved back towards looking at overall returns rather than returns on projects, and at overall long run prices rather than at prices of specific services. It developed the notion of a required rate of return to be applied to the future capital programme as a whole. But the important issue of the return on existing assets was not addressed. This latter issue was first explored officially in the first part of the 1980s, when a group of accountants and economists came together to advise the Treasury on the use of accounting policies in achieving a proper return on nationalised industry capital. In this group, we used deprival value as the correct approach to asset valuation, linking it to the need to make an appropriate return on assets after maintaining real financial capital. This was heady stuff, and met plenty of opposition, not least from the nationalised industries themselves. It was intellectually challenging and intellectually productive. But it was not tested in practice. Who knows what would have resulted had privatisation not intervened! I am glad to say what that might mean.

But Sir Ian Byatt, the last pre-privatiser Finance Secretary, in 1989, said that privatisation turned out to be an ideal opportunity to establish proper incentives and to making good decisions. But simple numbers are the key to good decision making.

3. Peter Holgate: uses of deprival value
I have been asked to say a few words about deprival value from the perspective of accounting standard setters in the UK. From my time on the technical staff of the Accounting Standards Committee (1981 to 1986) and more recently as a practitioner, I have followed this subject with some interest. As we know, deprival value is defined as the lower of current replacement cost and recoverable amount (Baxter called this ‘future contribution’). Recoverable amount is the higher of value in use (net present value of cash flows) and net realisable value. Deprival value has been much championed by Will Baxter, though he acknowledges that ‘the concept was probably first discussed in depth by Professor J.C. Bonbright of Columbia University’. Baxter (1984), in a work on inflation accounting, notes that ‘it [deprival value] has been tacitly adopted by the British Standard...
setvaluations, but is sadly neglected in the USA’. Deprival value has indeed been used by UK standard setters extensively, though not by that name. It was generally called ‘value to the business’ or ‘current cost’. As such, it featured in the Sandilands Report (HMSO, 1975), the Exposure Drafts ED 18 (ASC, 1976) and ED 24 (ASC, 1979) and the Statement of Standard Accounting Practice SSAP 16 (ASC, 1980). It also featured in the Accounting Standards Committee’s Accounting for the effects of changing prices – a handbook (ASC, 1986). During the 1990s it found its way into the Accounting Standards Board’s Statement of Principles (ASB, 1999).

Of course, the inflation accounting story in the UK was not exactly a happy one. In the mid and late 1970s, there was high inflation which was seen to be distorting the measurement of profits and assets. Although there was some agreement that this was a problem, there was little agreement as to what should be done about it. For one thing there was the dispute about whether to use Current Purchasing Power (CPP) or Current Cost Accounting (CCA) – i.e. general inflation restatement or accounting for specific price changes. CCA ‘won the day’ but its day lasted, as it were, only for a few years. After Sandilands and two exposure drafts, SSAP 16 was put in place. It never was popular and, although there was initially good compliance with it, a few refused and gradually more and more companies joined them, rendering it unenforceable. There was really no effective enforcement regime at the time. Eventually, by about 1984, SSAP 16 had to be withdrawn. Of course that does not mean it was in any sense wrong – SSAP 16 had to be withdrawn for wider reasons. It was not the case that people disagreed with deprival value (or current cost) as a basis for measuring assets. It was because of objection to the inflation accounting proposition as a whole; its complexity; the lack of understanding by companies and users; the effect of reducing profits – not popular with finance directors and even less popular with chief executive officers; the fact that tax was levied on an historical cost basis; and the fact that inflation was high in the mid and late 1970s but started to reduce in the 1980s.

In the downfall of SSAP 16 there was no significant objection, as I recall, to the notion of deprival value. Indeed today, when assets are revalued selectively, the deprival value notion plays a major part. For example, the revaluation model of the International Accounting Standard IAS 16 Property, Plant and Equipment requires that assets are stated at ‘fair value at the date of the revaluation, less any subsequent accumulated depreciation and subsequent accumulated impairment losses’ (IASB, 2007: para. 31). Time does not permit a discussion of fair value and what that means (for example the US standard setters are currently re-engineering it to mean exit value, i.e. likely disposal proceeds), but we can see part of deprival value in the words ‘less impairment losses’. Indeed, deprival value is central to the UK and IFRS approach to impairment (whether the asset is at cost or at value of some kind). A discussion paper on Measurement at Initial Recognition (IASB, 2005) analyses a number of options and included on page 61 is deprival value. Nor is its use confined to assets. Baxter’s model in the context of liabilities is called ‘Relief Value’. Andrew Lennard, as technical director of the UK Accounting Standards Board (ASB) has published a paper on Liabilities and how to account for them (Lennard, 2003). So we can safely say that Baxter’s ideas live on in many ways – in relation to liabilities as well as to assets and, perhaps more importantly, in North America and on the international scene as well as in the UK. To be fair, much of this ‘living on’ is in institutes and standard-setters, as well as in universities. But it also lives on in what passes for the real world. I was giving a seminar to some non-executive directors recently – mostly about the development of International Financial Reporting Standards – and in the ‘questions and answers’ session one of them asked me whether any work was taking place on inflation accounting. He pointed out that inflation was currently low but might not always be. Was there any contingency plan for inflation accounting? I had to acknowledge that it had received very little attention in these recent years – due largely to low inflation. What attention there had been was centred on financial instruments and pensions, in contrast to the focus of SSAP 16 Statement of Standard Accounting Practice (ASC, 1980) on non-financial assets such as plant, equipment and inventories. I also had to acknowledge that if it did recur, there would be a whole generation of accountants and business people asking – as if for the first time – questions about how to account for inflation. I wonder where they will look for guidance?

4. Professor Michael Bromwich: the summit of accounting theory

Professor Bromwich summarised the range of normative theories of valuation that were developed, debated and discussed over several years. He described the debate, played out in books of exemplary analytical standard as ‘the battle of the ought-to’. The theories drew on social sciences, principally economic analysis. As examples, historical accounting was supported by Fjiri (1975) while the concepts underpinning historical cost...
accounting were analysed by Paton and Littleton (1940). Exit values were supported by MacNeal (1939), Chambers (1966) and Sterling (1979). Entry values, based on replacement cost, were favoured by Edwards and Bell (1961). Opportunity cost, which featured prominently in Baxter’s discussions, is found also in Cannings (1929). The concept of deprival value as a means of reconciling positions on exit prices and entry prices, depending on the choices available to entities, is described by Solomons (1966) and Baxter (2003) drawing on principles set out by Bonbright (1937) whom Baxter had visited. Bromwich pointed out that the authors of these works, including Baxter, thought about value throughout their working lives. There is an irony that those who could influence standard setting, particularly the Financial Accounting Standards Board in the US, appear to prefer that management judgment should not have a role in the measurement of assets and liabilities. Professor Bromwich concluded with the view that we need the judgment of managers in valuation.

5. Shyam Sunder: not by Will – Baxter and the rise of authoritative accounting standards

Scholars retain their perspective in the face of opposition, ignorance, fashion-of-the-day, even prejudice. Access to the ears of princes rarely helps either the scholarship or the authority. William T. Baxter was among the first, if not the first, to recognise and articulate the deleterious consequences of authoritative measurement standards for accounting as a profession, academic discipline, and subject of university instruction. Yet, his career coincided with the rise of such standards. Today, as we stand at the verge of global triumph of standards and authority over individual analysis and judgment in accounting measurement, doubts about the wisdom of this approach are beginning to take hold. Baxter would be too gracious to have the last laugh.

Unlike most people here, I did not have the opportunity to study as Will Baxter’s student. I met him a few times during his visits to the United States and my visit to the London School of Economics. I know him mostly from his writings, especially about the role of authority in setting and enforcing accounting standards. In these remarks, I would like to outline how his writings have affected my own thinking and work.

First, Baxter was not opposed to accounting standards per se. He recognised the value, indeed the necessity, of many kinds of standards to make our life, in accounting and elsewhere, easier and tolerable. Rules of the road – drive to the left (or right, as the case may be) is a familiar example. Life would be difficult without the coordination facilitated by standards. In a recent working paper, Karim Jamal of the University of Alberta and I (Jamal and Sunder, 2006) found that in the US alone there are more than 500 standard-setting organisations and more than 15,000 standards developed by these organisations are in place. We take for granted the convenience of standards for voltage of electrical power, internet protocols, even height of the tables and chairs in this room. Better coordination of our activities is prized in human societies. Standards serve that function in all walks of life. Financial accounting standards are just a special case.

What, then, were Baxter’s reservations about standards? He was skeptical, even critical, of measurement standards backed by the enforcement power of authority. There is no compelling reason for a single theory or conceptual framework for financial reporting – whether it is fair value or stewardship – to receive the imprimatur of authority over others (FASB, 2006). Theories must be left for open debate and judgment to be resolved by logic and evidence, not authority. Baxter, worried about the deleterious effects of authoritative pronouncements on the nature of practice, scholarly debate, content of textbooks, classroom disclosure, and ultimately on the quality of talent that might be attracted to a profession which is reduced to a search of the rule book. Search engines are free, and so will be the ultimate value of the services of an accountant stripped of the freedom to contemplate and exercise judgment.

Although Baxter wrote his analysis more than half a century ago, his words sound incredibly prescient today:

‘Similarly, official recommendations by an institute of engineers would have to be framed with some care. Assume, for instance, that it advised its members to build bridges in a uniform way, based on the best current knowledge. For a while, standards might well be raised. But research would in time point to better bridges; nonconformist bodies of engineers would be free to build these, while the orthodox would be denied the fruits of advancing science.

‘… Authority may thus rest (at one end of the scale) on prestige only, and (at the other) on power. Occasionally the brilliance of a single thinker can cause his views to be treated with deference. A close-knit school of able thinkers may well dominate opinion to an unhealthy point – even if they lack organisation and can impose no sanctions. The harm becomes vastly more formidable when the authority controls education, or can mould adult opinion. It reaches its worst when authority has total power. In its extreme forms, we are all agreed that it is evil – and that the evil persists whether or not the
views that it promulgates happen to seem true or false.’ (Baxter, 1951, in Baxter and Davidson, 1962: 421–2)

Second, Baxter understood all too well the false dichotomy of positive and normative research, and the unhealthy consequences of the dichotomy for a discipline like accounting that must keep one leg in social sciences and the other in engineering. Starting from the 1950s criticism of management programmes in the US as a wasteland of vocationalism, the pendulum of scholarship swung towards social sciences to the present state in which policy research has become a dirty word in some accounting circles. Baxter’s second concern was a judicious balance between scientific aspects of accounting and the policy implications of what we do. We cannot risk being just social scientists, nor just prescribers. In the domain of business, we must bear the burden of doing both – the physics as well as engineering of management and accounting.

This approach is illustrated beautifully by the inclusion of Jack Kitchen’s article ‘Costing Terminology’ in Baxter and Davidson (1962). Kitchen (1954) pointed out simply, but brilliantly, how meaning in language must depend on uncertainty. The value of a word – ‘cat’ or ‘house’ or ‘assets’ – would be lost if it could only be used for exactly identical objects. ‘House,’ for example, is a general concept, referring to a variety of existing and not-yet-conceived-of constructions. Whether the word ‘house’ is to be used for a particular construction must necessarily remain a matter of judgment of the speakers. This centrality of judgment and variation in usage is the essence of all natural languages. When we strip the language of ambiguity and variation in meaning, we reduce it to something artificial and sterile (Fearnley and Sunder, 2006). The logic as well as the social science of linguistics leads to deep skepticism about the value of officially declared definitions by accounting institutes that Kitchen criticised. The value of the Oxford English Dictionary derives not from its enforcement authority but from its encyclopedic inventory of usage of words in the past and present. Dictionaries compete for our allegiance in a world with less than perfect coordination of speech. English dominates the world today not because an official academy defines and enforces correct usage, but because of its flexibility and openness to new words and new usages of old words.

Finally, I would like to mention Baxter’s deep concern about the impact of authoritative standards and definitions on education and attracting talent to the accounting profession. He wrote:

‘The recommendations must therefore have a considerable influence on the thought of the mature accountant. On the immature mind – that of a young man in training – their impact must be deep. They are given conspicuous place in his textbooks and correspondence courses, and so they are likely to lead a brisk argument. Even before the days of recommendations, accounting textbooks and teachers preferred in general to state facts rather than explore theories. Their main concern was painstaking description of normal practice; scant space was accorded to the reasoning behind the practice, and next to nothing was said of controversy. This dull and sterile approach has now been made far more likely. If an official answer is available to a problem, why should a teacher burden his examination candidates with other views?’ (Baxter, 1951, in Baxter and Davidson, 1962:422–3)

Fortunately, as their more recent proposals suggest (FASB, 2006), the Financial Accounting Standards Board and the International Accounting Standards Board may yet benefit from Baxter’s thought.

6. Joanne Horton: continuing debates over deprival and relief value

It is an honour to have been invited to contribute today to this Symposium celebrating the work of Will Baxter. Although I was never his student I feel as though he was one of my most important teachers, as everything I learned about financial accounting and reporting in my degree at Aberystwyth centred on Hicks and deprival value. And now I find myself teaching the MSc students here at LSE the equivalent of the ‘valuation theory’ course that Baxter used to teach them: we still teach Hicks and deprival value.

Why is the concept so basic and so important? Because it links asset values to the underlying Hicksian notion of ‘well-offness’ in terms of the value of expected future cash flows: which in turn links to the finance that our students are also learning. And although Baxter himself was, in recent years, dubious about treating the ‘relief value’ of liabilities as the mirror image of the ‘deprival value’ of assets, at least some of the important insights surely do carry across, as may some of the weaknesses, e.g. how to deal with ‘aggregation’ or what standard setters now call ‘unit of account’ problems.

Standard setters currently seem much more interested in ‘fair value’. And of course in deep mar-
kets like those for many financial instruments, as deprival value is always limited by entry and exit values and in good markets those values increasingly converge, then for financial instruments at least there may not be much practical difference in thinking of ‘fair values’ rather than deprival or relief values. But as Richard Macve and I pointed out (Horton and Macve, 2000) – in an article which our MSc students seem to find helpful – there are grave theoretical inadequacies from pursuing fair value, particularly in the case of liabilities.

One well-known difficulty arises from changes in creditworthiness. Other things being equal, if a company that has issued a liability instrument such as a debenture has its credit rating downgraded, the price of that debenture on the capital market will fall. Under ‘clean surplus’ accounting a fall in a value of a liability must give rise to a recognised gain. Is the company really better off? It seems counter-intuitive, even though the usual explanation is that it represents the increasing value of the shareholders’ ‘limited liability put option’ as the company’s perceived probability of loan default increases. What is missing of course is the effect of the credit downrating on, possibly, the company’s asset values and, certainly, its unrecorded goodwill. These must surely greatly outweigh the apparent gain on its recognised liabilities, so that equity value has declined and it has a loss. In other words to get to the sensible answer, one really needs to ask the underlying question behind the deprival value approach: ‘how has the present value of the company’s future cash flows been altered’?

Even without the creditworthiness problem, one also needs to go beyond the kind of deprival value examples that mainly feature in Baxter’s books, where market interest rates normally are assumed to be unchanging. If interest rates rise, the values of liabilities fall. Again, clean surplus accounting implies a gain to equity shareholders but clearly the rate now implicit in the loan at the new value is higher, so future years’ income statements will suffer accordingly. Moreover, while exit value (or fair value) seems to offer only one solution, deprival or relief value, even if producing the same number for the liability, will make us think twice before recognising any gain. Indeed, if the loan is anyway due to be redeemed at some set date in the future, the company must, other things being equal, now be worse off since, when that day comes, any refinancing must now be at a higher rate. It is not necessarily the case that the present value of future cash flows has worsened but that certainly the company’s ‘maintainable cash flow’ (and therefore maintainable dividend to its share-holders) has fallen. So we need to look rather at Hicks’ ‘No. 2’ version of income. The crucial thing is that thinking about value from this perspective, as deprival or relief value does, is making us ask the right questions about ‘what difference does it make?’, that fair value sweeps under the carpet. It asks the questions that managers should be asking about how to maximise NPV and how to deploy assets and structure liabilities to do so.

Finally, what happens when we move away from the relatively deep markets of traded financial instruments to the much thinner markets for liabilities like insurance liabilities – a particular research interest of mine? Standard setters in their mission for ‘fair value’ now have been obliged to construct a ‘hierarchy’ of methods for arriving at fair value as the availability of reliable market benchmarks declines. At the lower levels of such a hierarchy one is, albeit reluctantly, effectively at the level of manager’s own estimates of the future cash flows to be obtained from an asset (or to be met in respect of a liability). Deprival value/relief value thinking accords such estimates their proper place: they are always relevant to managers’ decisions, but can only be relevant to value (in the case of an asset) where there is no lower replacement cost. It is presumably relevant in the case of a liability where taking on an equivalent obligation would now bring in a lower cash receipt. This argument supports the position that the IASB’s insurance working party was until recently increasingly, but still controversially, moving towards a position where insurance policy liabilities would have to be measured by reference to what policyholders are now being charged, not by reference to what insurers think they can settle or transfer them for (generally lower). The IASB itself, however, has now overruled the industry’s common sense, as embodied in that approach, in favour of exit price, which must inevitably produce the highly controversial ‘Day 1’ profits on inception of an insurance contract. So there is still plenty of work to be done here at both a practical and a conceptual level to explore further what are the relevant valuation ideas and what are the related relevant income (or ‘performance’) measurement issues.

I hope I have said enough to indicate why we still teach deprival value thinking to our students. Despite the apparent fashion for ‘fair value’ it is deprival value/relief value that makes one ask the right questions, even if the answers may no longer be so clear as standard setters would wish them to be.

7. Ken Peasnell: deprival value today
Professor Peasnell expressed his pleasure at the invitation to speak about deprival value at this event, as a subject that he first heard about from Will Baxter when Peasnell was a MSc student at

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4 For example the Financial Accounting Standards Board’s Statement No. 157 Fair Value Measurements (issue date 09/06).
LSE 36 years ago. Peasnell has written various pieces on the subject over the years, and noted that when he did so Baxter was the first person to whom he turned for views on a paper’s arguments.

Bonbright (1937) is usually credited with introducing the familiar deprival value model to accountants, via the works of Wright (1964), Solomons (1966), Baxter (1967, 1971, 1975) and Parker and Harcourt (1969). Deprival value came to the attention of UK practitioners when it was made the proposed valuation basis in Sandilands (HMSO, 1975) and finally in the short-lived inflation accounting standards – SFAS 33 (FASB, 1979) in the USA and SSAP 16 (ASC, 1980) in the UK, and similar standards or proposed standards in other countries. Deprival value has lived on, in the UK at least, through standards concerned with asset revaluation. An interesting current question is how it relates to the ‘fair value’ concept advanced by FASB and IASB for financial instruments, an issue I touch on briefly later.

Baxter was a man who greatly prized precision of argument and expression. In that spirit, I will start with some notation. The familiar version of the model can be succinctly expressed as:

\[ DV = \min[RC, RA] \]

where \( DV \) represents deprival value, \( RC \) is an asset’s replacement cost and \( RA \) is the ‘recoverable amount’ made possible by current ownership of the asset:

\[ RA = \max[PV, NRV] \]

\( PV \) represents the present ‘value in use’ and \( NRV \) the net realisable value.

One criticism that has been made of deprival value is that it appears to perpetuate the accountant’s traditional conservative ‘lower of’ orientation and, as a result, to mix valuation bases (Chambers, 1970). That is an error, but it is an understandable one, given the way the conventional formula expresses deprival value as the lower of replacement cost and recoverable amount. However, no student of Baxter who listened carefully to what he had to say should have made such a mistake.

What is so impressive about Baxter’s contribution is that he always argued from first principles. For him, deprival value was a process of comparing budgets or values with and without the asset:

\[ DV = PV(\text{with asset}) - PV(\text{without asset}) \]

To see the connection between the two specifications, let us rewrite the familiar model, \( DV = \min[RC, RA] \), by adding and subtracting \( RA \) to obtain:

\[ DV = RA + \min[RC - RA, 0] \]

\[ = RA - \max[RA - RC, 0] \]

In other words, the deprival value is the amount by which the firm is better off from owning the asset: it is the higher (not lower) of two values. That is the good news. The bad news is that determining the RC of a long-lived asset might entail forecasting far into the future – hence Baxter’s long-standing interest in depreciation, and the concern of many about its inherent subjectivity.

A key issue with deprival value is the extent (and direction) of the ‘spread’ between entry (RC) and exit (NRV) values. To see this, group the various possibilities as in Table 1.

It has been commonplace over the years to regard deprival value as being best approximated by replacement cost. However, as Table 1 makes clear, this implies that \( NRV > RC \), which might be expected to apply in goods markets where the buying (wholesale) and selling (retail) markets are segregated such that it is not easy to arbitrage between the two. To the extent that we can safely regard \( NRV < RC \) as being the normal case (as it would be in markets for financial instruments, for example), we know that deprival value must lie somewhere within the bounds set by the RC-NRV spread. If this spread is very narrow, there will be little ambiguity about deprival value: it will be (roughly) equal to market price. This issue has become topical again, through the introduction of ‘fair value’ accounting by the standard setters. The essential idea of fair value is that it is an arm’s length market price, usually taken to mean the selling (or bid) price.

More recently, van Zijl and Whittington (2006) have tried to bridge the gap between fair value and deprival value, by focusing on the situation where \( NRV > RC \). This can arise in three main ways:

- Inventory held for sale, in the normal course of business.
- Property in a location with higher alternative use-value.
- Excess capacity (might have option value).

In all three cases, the deprival value algorithm suggests \( DV = RC \), which could be argued to un-
derstate value to the firm because it ignores these additional sources of value.

In their discussion of the deprival value formulae, van Zijl and Whittington (2006) propose modifying the formulae by adding the sale profit = NRV−RC (which can be thought of as the ‘intrinsic value’ of the ‘option to sell’) to conventionally-determined deprival value if, and only if, this sale profit is positive (see Table 2).

Firm-specific factors still arise when NRV<RC, but are limited to the ‘spread’: NRV < DV < RC. But now we have four situations where (modified) deprival value is equal to NRV; as such, the gap between it and the fair value concept favoured by
the standard setters is greatly reduced. Fair value will still tend to overstate deprival value, but less often so.

It should not be overlooked that the option to sell incorporated by van Zijl and Whittington into deprival value is measured at intrinsic value, not economic value. This will lead to an understatement of deprival value, should the option have long to run and the uncertainty of the benefits be high.

There are other embedded options that come to mind. For example, Stark (1997) raises the issue of what to do with the ‘option to wait’ when considering replacement. Suppose we represent the economic value of this option as OW. Stark shows that the deprival value formula needs to be restated as shown in Table 3.

The two options can be readily combined. The application of deprival value (fair value too) involves the introduction of subjectivity in all markets when entry and exit prices differ. This runs down the fault line of academic opinion:

- Subjectivity allows management to communicate additional information.
- Subjectivity introduces the spectre of earnings management and reduces the usefulness of accounting numbers as measures for contracting purposes.

How all this will play out remains to be seen. Baxter wrote about valuation and income measurement during inflationary times, and his contributions must be viewed in that light. Inflation has been largely tamed – for the time being. But it is a brave person who will predict that it has been tamed forever. Global warming is going to change the world’s landscape in more ways than one; past experience suggests that the resultant turmoil will bring inflation in its wake, and for that we need appropriate tools. Baxter’s works lie waiting for such a time.

8. Professor Richard Macve: Conclusions

What have we learned today? The foundations laid by Will Baxter at the London School of Economics (together with David Solomons and Harold Edey) still underpin the core of understanding about accounting that inspires much academic teaching and research, and increasingly practice. And even though many of Baxter’s students have themselves become leading ‘establishment’ figures in accounting and finance, including as regulators and standard setters, Baxter’s admonition (following Bacon) that ‘truth is the daughter not of authority but of time’ reminds them to be circumspect in claiming too much ‘authority’ for their pronouncements and that they continually need to rise to Shyam Sunder’s appropriately American counterchallenge to ‘let freedom ring’.

We have seen how ‘deprival value’ (and its complement ‘relief value’ for liabilities) is still central to the teaching of Financial Accounting and Reporting on the BSc and MSc at LSE – because we think it makes one ask the right questions about value, income and decision making.

I remember Baxter observing that the more one studies accounting the more one realises that it is not the actual numbers produced that are so important as the discipline of the process by which they are arrived at. Here perhaps is a cryptic beginning of what was later to be developed at the LSE, studying how the process of accounting as a ‘calculative routine’ both shapes and is shaped by organisational, institutional and other social factors. Above all, as so many of the tributes in the book of reminiscences6 testify, Baxter taught us that our job in attempting to understand the truth is to do our utmost to explain complex issues and ideas in as simple a way as possible, and to eschew the pretensions of those who seek to obfuscate and turn what is simple into something unapproachably complex.

References

Editorial note: This list includes a number of historical works that may not be readily available in all libraries. While there is no substitute for studying original works in full, the readings contained in Baxter and Davidson (1962 or 1966), Parker, Harcourt and Whittington (1985) provide excellent coverage of the range of issues faced in developing theories of measurement in accounting.


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6 A Book of Reminiscences was presented to Mrs Leena Baxter at the Symposium.
Accounting Theory (2nd ed.). London: Sweet and Maxwell.