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Symposium 1

Wanted: Foundations of Accounting Measurement

The case for entry values: a defence of replacement cost

Andrew Lennard
Director of Research
Accounting Standards Board

a.lennard@frc-asb.org.uk



Asset measurement– general points

- § Extent to which asset makes the entity better off
- § Different assets benefit different entities differently, so
- § Measurement must be entity-specific
- § Profit maximising behaviour should be assumed



Why replacement cost? (1)

- § Represents value to the entity—extent to which ownership benefits the entity
 - returns may be higher, but they lie in the future and will still be obtained if asset replaced
- § Performance measured against current costs
- § Enables performance to be analysed between operating and holding



Why replacement cost? (2)

- § Clean break between operating and holding gains
 - *(Sprouse & Moonitz, Edwards & Bell, pace Drake & Dopuch)*
- § A business is a bridge between markets
- § Inputs measured at current input prices
- § Sales measured at current output prices
- § Profit is the difference
 - and should be seen in context of current asset values



Using replacement costs

| | | |
|------------------|----------------------------|----------|
| Sales | (Money got from customers) | 100 |
| Cost of sales | (Current purchase price) | (80) |
| Operating profit | | <hr/> 20 |
| Holding gains | | 10 |
| Net profit | | <hr/> 30 |

Cf IASB project: Financial Statement Presentation



Replacement cost: revenue recognition

- § Payments received in advance
- § Performance will cost less than amount received
 - so entry is greater than settlement
- § Liability remains until discharged through performance

Cf IASB project: Revenue recognition



Arguments against replacement cost

§ Asset is not owned

- Existing asset can (should) be valued against alternatives

§ Fails to show command of goods in general

- Does show command of business resources

§ Increases in buying prices are bad news

- Financial statements do not show 'bad news'



FAS 157 arguments for exit values

- § Asset is already owned
 - but value can be obtained through use rather than sale
- § Consistent with asset definitions
 - but definitions were never intended to specify measurement
- § Recognise returns from superior skills when realised (not before)
 - but replacement cost does not recognise returns



Replacement cost: confusions

- § CCA legacy
- § Normal replacement assumption
- § Reproduction vs replacement
- § Technological change
- § Not always practicable



Replacement cost: limitations

- § Impaired assets
- § Business constraints

The point at issue... is not
whether to value by current entry or exit prices
but *when* to shift from entry to exit values
(Edwards)



Impact of the financial crisis: a personal view

- § Debate initially focused on fair value vs historical cost
- § Case for current values is reinforced
- § But what kind of current values?
- § Does manufacturing have a future?

