THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE
Department of Accounting

Wanted - Foundations of Accounting Measurement

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- So-called 'measurement objective' should be to meet objective of financial accounting and reporting (e.g. in FASB/IASB Conceptual Framework)
- But concerns with CF: single objective for homogeneous users and uses? Or multiple (e.g. 'economic decision making' and 'legal/contractual' uses)?

My naïve principle (based on auditing experiences a long time ago…):

- Information that is useful for and used by managers more likely to be reliable than information that is only produced to satisfy external reporting requirements
- But FASB fear management manipulation and seek 'objective statistics' (original 'myth' of Fair Value—based in Financial Economics? Cf. Bromwich, 2007; Hitz, 2007; Dean, 2008).
- Yes, important to 'triangulate' management values against external market evidence (especially now…)
- But in current markets is even Level 1 FV now reliable? (cf: FASB's new FSP on FAS157-4; also on FAS115-2, FAS124-2 re impairments)

Remember Pacioli (1494)!

- *'E fallo grasso piu presto che magro, cioe se ti pare che vaglino 20 e tu di 24 etc. acio che meglio te habia reuscire el guadagno.'*
- '... distinguish clearly each item... assigning the usual value to each. *Set the price higher ('fatter') rather than lower ('leaner'), so that if you believe it is worth 20, attribute 24 etc. so that you can more easily obtain a profit*' (trans: v. Gebsattel, 1994, p.54).
- i.e. for the balance sheet, Pacioli does not hesitate in recommending a measurement choice on the criteria of what he regards as most useful, and most likely to have desirable behavioural and economic consequences:
- His bias towards overestimating the 'usual value' suggests that target pricing, not historical costing, is where he starts from (Macve, 1996). So objective(s) of accounting crucial.
- Plantin et al (2008) explore potential adverse behavioural consequences of FV for financial institutions– unfortunately they don't understand normal accounting practice… … .

What about liabilities and FV?

1. Financial instruments: if not traded, paradoxes of 'Hicks I' [has value changed?] vs. 'Hicks II' [has maintainable income changed?]– e.g. Bromwich et al., 2009; and changes in credit risk (e.g. Macve, 1984; Horton & Macve, 2000)
2. Other: 'deferred revenue' for contracts (e.g. Macve & Serafeim, 2009). NB: latest IASB/FASB DP on revenue recognition (Dec 2008) is against a FV which would give a 'Day 1' profit as Boards' members 'uncomfortable'. A new CF concept?
3. Pension/Insurance liabilities: immediate transfer (FV / 'CEV'?) or 'settlement over term'? (e.g. Horton et. al, 2007)

A role for 'Deprival Value /Relief Value'?

- Takes us back to the 1970s debates on 'inflation accounting'.
- ASB has been brave enough to continue advocating it (and also AARF 1998).
- Superficially similar to traditional 'lower of HC and recoverable amount': but HC *per se* cannot be decision relevant (cf. Penman, 2007).

Deprival value

- Often expressed diagrammatically in a decision tree:

DV = lower of

RC | higher of[1]

NRV | PV

- or as min [RC (max NRV,PV)]

- 'Mirror' for 'relief value' of liabilities?

[1] Commonly referred to as 'recoverable amount'

Deprival value (cont.)

- But there can be dangers in the simple pedagogical tree (and ranking tables derived from that: e.g. Van Zijl, T. and Whittington, 2006; Weetman, 2007).
- e.g. for depreciating assets, where Baxter's *Depreciation* (1971) showed 'replacement cost' needs interpreting as 'the adverse consequence of deprival on the present value of all future cash flows, given that the asset now has to be replaced earlier than planned'.
- PV criticised as subjective: but as markets get deeper, RC and NRV more readily available: and DV *always bounded by these* (so tends towards FV).

Fending off the politicians?

- Recent political interventions in the crisis (e.g. France) have strengthened 'technical' accounting calls to rally round and support FV to demonstrate FASB/IASB's independence
- But as noted, even for Financial Instruments FV has many problems, especially for income measurement
- And the world is not just banks… .
- US contribution to debate beyond Financial Instruments has been weak given longstanding SEC opposition to anything but HC (e.g. Zeff, 2007)
- So US / Canadian standard setters generally dismissive of DV, as have previously had little reason to debate measurement bases for other assets (or liabilities)

Concluding remarks (1)

- No measurement approach is 'Pareto superior' to others for *external users;* but Deprival Value/Relief Value *is* for internal use by managers, as it's not a measurement basis *per se* but a rule requiring consideration of the other bases (but not HC– *nor FV?!*) to determine which is relevant outcome in each situation if 'best' decision between alternative actions is made.
- So if managements *explain* their balance sheet values by reference to external (market) benchmarks, that could be useful to external users
- But still leaves 'aggregation problem', i.e. what is relevant asset to value (Edey 1974)?

Concluding remarks (2)

- Standard setters' exclusive focus on Assets and Liabilities has almost driven out any direct conceptual debate on 'income measurement' / 'earnings' (other than tinkering with presentation).
- But earnings / profit is what users seem primarily interested in for 'ordinary' companies (e.g. Penman, 2007). And Boards' members now need to be 'comfortable' with profit pattern… .. (DP on Rev. Rec)
- So what is best for balance sheet may be different for income statement? (But now FASB/IASB apparently considering removing 'Available for Sale' category of Fin Inst?– the opposite of Horton & Macve, 1996… …)

Selective further reading: NB several showing concerns with FV well *before* the crash!

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Selective further reading (cont.)

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