Measurement in Financial Reporting

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The central thesis

- Much of the thinking of standard setters about measurement seems to be based on an idealised view of markets as *complete* and in *perfectly competitive equilibrium.*

- Hence the perceived enthusiasm for single 'ideal' measurement methods, such as *Fair Value* and the *Fair Value Hierarchy*.

- In reality, markets are imperfect and incomplete: the existence of *information asymmetry* is the reason why we need accounts. The Current liquidity crisis demonstrates the limitations of markets even for financial instruments.

- *Measurement methods* should be selected with the market context in mind: accounting provides *information*, not definitive aggregate measures, so having a single measurement method may not best meet user needs.

Is there a ‘best’ measurement method?

- IASB/FASB started with the intention of selecting the *single* measurement *method* that best conforms with criteria such as relevance and representational faithfulness.

- *Other methods* would be allowed only as *proxies*, as in the *Fair Value Hierarchy.*

- *Mixed measurement* assumed to be bad (mis-matches, etc.)

The case for a single ideal measurement method

- *Comparability* across entities.
- *Consistency* within accounts, avoiding *mismatches* and allowing meaningful *aggregation.*
- In the case of *Fair Value*, *objectivity* (non entity-specific) and *relevance* (prediction of future cash flows, Barth 2006 and 2007, Hague 2007).

The case against

- Markets are *imperfect ,incomplete and in disequilibrium*.
- *Information asymmetry* is an important aspect of markets (Grossman and Stiglitz, 1980), and that is why accounting is needed (Beaver and Demski, 1979).
- Hence, ideal market measures do not always exist, and accounts should aspire to provide useful *information* (input to valuation models) rather than complete *measurement* (what are analysts for?).
- The recent *credit crisis* has drawn attention to market failures, and the IASB appears to have broadened its measurement project to include alternative measurement methods.

The inappropriateness of Fair Value

- FV is predicated on an *idealised* complete perfect market equilibrium, where market prices are readily observable and reflect the cash flows obtainable by the marginal trader.

- FV deliberately *ignores entity-specific opportunities*, yet the accounts report the state of the entity, and these opportunities are those which are actually available (in an ideal perfect market, different entity-specific values would be arbitraged away?).

- FV focuses on *price*, not net flow from an actual opportunity to sell, so *transaction costs* are ignored (a frictionless market is assumed?).

- FV uses only *exit* (sale) prices, whereas *entry* (replacement) costs may better capture the cost of using assets (and therefore margins) in a going concern business. Equally, *recoverable amount* allows exit through use: an important issue for financial instruments in illiquid markets (but perfect and complete markets are not illiquid: there is a price for everything).

The alternative approach

- Where markets are imperfect, accounts aid decision-making but are not deterministic : inputs to models but *not complete information*.

- Just as ‘different costs for different purposes’ applies for management decisions, *‘different measures for different purposes’* applies to financial accounting, e.g. cost measures may provide useful margins for projecting operating cash flows (Penman, 2007), whereas fair values may be more direct means of valuing investment portfolios.

Limiting the range of methods

- It would be impractical, expensive and possibly confusing to report many alternative measures. How do we *limit the range*?
- Decide on a common measurement *objective*, which may allow different *methods* in different circumstances.
- Under the current conceptual framework, such an objective might be to provide information *relevant to the economic position and performance of the entity.*
- *Deprival value* is one such measurement objective . Measures the *opportunities* facing the entity by reporting the opportunity that a profit-maximising firm would select, according to the specific circumstances.

Deprival value

- DV is a *possible measurement objective,* overcoming some of the objections to FV.

- But DV has its own *problems of implementation* (needs 3 different measurement methods, including highly subjective value in use), and the essence of an informational approach is that the appropriate measurement is contingent on the decision, the circumstances and the model of the decision-maker, so that no particular measurement objective will meet all needs.

- Hence, we should be modest in our claims, and *realistic* about the inevitable limitations of financial reporting.