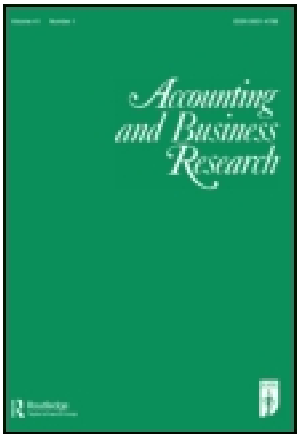


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# Discussion of ‘Standard-setting measurement issues and the relevance of research’

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# Discussion of 'Standard-setting measurement issues and the relevance of research'

**Stephen Cooper***

Mary Barth's paper sets out how standard setters approach measurement and how research can help in the resolution of some of the problems standard setters face. It includes many comments on the desirability of fair value measurement and use of a single measurement bases to avoid the undesirable effects of mixed measurement. It is these aspects of the paper that I focus on in this response. In my view, while the use of fair value is important in financial reporting, it should not be considered a panacea.

The paper commences with the observation that the IASB's *Framework* (IASC, 1989) does not include much guidance on measurement, although the current project to revise the *Framework* does include a separate phase on measurement. It is indeed disappointing that this crucial component of accounting is so underdeveloped in conceptual terms; consequently, it is not surprising that what has resulted is a large number of different measurement bases applied in different standards, often with little underlying logic.

Alternative measurement bases are often compared with each other in isolation and without considering how changes in fair value, and consequently corporate performance, would be presented. Standard setters are often accused of having a balance sheet rather than income statement focus. However, the paper explains that defining and measuring financial position element is necessary to measure profit or loss:

*'[T]he Framework focuses on defining financial position elements ... not because financial position is more important than profit or loss; rather, it is because profit or loss is important, and defining financial position elements is the only way standard setters have been able to determine how to measure profit or loss.'*

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The problem with this is that starting with the balance sheet does not necessarily produce the most *useful* measure of profit or loss, particularly where profit or loss becomes a mixture of fair value changes that reflect both current period items and also value changes related to changes in expectations.

On the merits of fair value as a measurement basis, the paper argues that this approach is relevant because it reflects present economic conditions, that fair values *'have predictive value'* and that *'standard setters are unaware of a plausible alternative'*. It may well be the case that fair value is a more relevant measure of an asset than, say, depreciated historical cost when considered in isolation; however, it is less clear that such a valuation is as relevant when the asset is used in a business venture in conjunction with others and where immediate sale is not intended. Also, while fair value reflects market, or sometimes management, predictions of future cash flows, this does not necessarily mean the measure has predictive value in the sense of an investor seeking to devise their own predictions. An approach that is focused on transactions and profit, with assets measured at depreciated historical costs, may well have more predictive value for an investor than a balance sheet comprising all fair values.

In criticising historical cost, the paper suggests that *'historical cost may not be a relevant economic phenomenon for users making economic decisions'*. It is true that historical cost is probably not relevant when making an economic decision in relation to that specific asset. For example, in deciding whether to sell an asset at a particular price one would be advised not to consider the original cost but rather some measure of current value such as what one could sell it for to another interested party or what value could be derived from the asset by putting it to use. However, not all economic decisions are made on an asset by asset basis, but are instead based upon the overall profitability of a business venture. Historical cost measurement and a focus on transactions may well be the best means of measuring that performance and hence in taking economic decisions related to that business.

A frequent criticism of fair value as a measurement basis is that it introduces additional subjectivity into financial statements. The counter-argument given in the paper is that such measures reflect managers' detailed information that is not necessarily available to others and that it mitigates the need for market participants to come up with noisy estimates based only on public information. This argument is very persuasive; it is important that fair value is provided in financial statements where the value of the individual assets and liabilities matters and where it is difficult for investors to arrive at a value independently. Measurement subjectivity should be dealt with by putting controls in place to ensure that estimates are as unbiased as possible and to provide disclosures so that the measurement subjectivity can be understood by investors.

The problem of mixed measurement is also addressed in the paper. It is claimed that *'fair value ... holds promise for minimising the undesirable effects of the mixed measurement approach'* and that *'using multiple measurement bases makes it difficult for financial statement users to separate accounting induced income or expense form economic income or expense'.*

It is true that mixed measurement does create difficulties for investors, and that the current somewhat ad hoc selection of measurement bases needs to be rationalised. For example, remeasuring pension liabilities due to interest rate changes but not remeasuring other debt obligations is illogical and makes analysis difficult. However, there may actually be good reasons to have a different measurement basis for say operating assets versus investments and financial liabilities, due to the different analytical approach adopted for each. Mixed measurement is only a problem if one believes that the balance sheet total and overall comprehensive income are important, whereas in practice most analysis focuses on components of these totals.

Typical business valuations deal differently with operating activities, investments and financial liabilities. For operations, value is generally based upon a discounted cash flow methodology or some other equivalent capitalisation of profits or cash flows. Often these calculations are carried out at the operating segment level. To determine equity value the estimated current market value of other non-operating assets and investments are added, with the resulting total estimated enterprise value then being allocated to the various providers of capital. In practice, this means deducting the fair value of debt instruments and non-common stock equity claims, such as stock options, to obtain estimated equity value. Considering this approach to equity analysis, in my view, the measurement bases that would be most useful to investors are as follows:

- **Operating activities:** a primarily historical cost or transactions approach to accounting with a focus on periodic profits and cash flows rather than balance sheet fair values. However, there should also be disclosure of alternative measurement bases so that investors can evaluate disposal options (exit value) and can better forecast the future cash flows that will arise from replacing assets (replacement cost). Also, fair value is necessary for certain operating activities or components thereof, particularly for financial services companies.
- **Investments and financial liabilities:** all assets and liabilities not classified as operating should be measured at fair value. Investors primarily focus on the balance sheet for these items not the income statement.
- **Equity instruments other than common shares:** to the extent that these instruments are not classified as equity then I believe they should be reported, as at present, at the transaction date price. However, balance sheet date fair value, and particularly the drivers of that value and the sensitivity of fair value to these drivers, should be disclosed.

The paper provides a good explanation as to why measurement is a key issue in accounting and why fair value as a measurement basis has many useful attributes. I agree that fair value is important and should be used for many items in financial statements, including some that are currently measured on an amortised cost basis such as financial liabilities. However, the problem in discussing measurement bases is that it is often done in isolation and with insufficient regard to the impact this decision has on arguably the more important issue of how to measure performance. For most companies it is performance and the ability to generate stable growing profits that investors primarily look for, with balance sheet net assets being of secondary importance. While measuring assets is necessary to measure performance, the evaluation of different measurement bases should (for most businesses) focus primarily on the usefulness of the resulting performance measures and not the completeness or accuracy of the balance sheet total.

## Reference

IASC (1989). *Framework for the Preparation and Presentation of Financial Statements.* Issued by the International Accounting Standards Committee and adopted by the International Accounting Standards Board in 2001. London: International Accounting Standards Committee.