Information for Better Markets

Measurement in financial reporting

Abstract

An initiative from the Institute of Chartered Accountants in England & Wales
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Directly or indirectly, financial reporting measurements – of performance and financial position – affect almost everyone, so any changes in the basis of measurement could be far-reaching in their effects. Growing controversy now surrounds the question of measurement in financial reporting – mainly because of a perceived movement away from the traditional basis of measurement (historical cost) towards a new basis (fair value). Given the importance of the subject, it has not attracted the interest it deserves. *Measurement in financial reporting* is intended to improve understanding of the issues and to promote and shape debate.

Financial reporting attempts to measure inherently abstract and debatable concepts such as income and net assets, and it has particular features that make it to some extent inevitably subjective and even arbitrary. It also tries to portray a reality that is constantly changing, partly in response to changes in measurement itself.

**Figure 1: The development of measurement practices**

Financial reporting measurement is therefore a matter of evolving conventions, not something to which there are immutably right and wrong answers. Yet the dominant style of thinking about measurement requirements hitherto has been a deductive one. It tends to assume that there is a theoretically correct answer, and then considers how this can be implemented in practice. The approach recommended here is radically different.

*Measurement in financial reporting* argues that the purposes of financial reporting depend on its institutional context and that this context also affects the costs and benefits of different measurement bases. It proposes that decisions on the regulation of financial reporting measurement should be regarded as matters of public policy, should be subject to the overriding tests of cost-effectiveness and fitness for purpose, and should be subject to the same principles of good regulatory practice as other forms of regulation.
It is proposed that any regulatory initiative should involve the following elements:

- consultation;
- making the case for change;
- options development;
- evaluation of options;
- planning implementation;
- mitigating remaining problems;
- implementation; and
- evaluation of results.

The relationships between these elements in a model of good regulatory practice are shown in Figure 2.

**Figure 2: A model of good regulatory practice**

'Making the case for change' puts the onus on showing that there is a problem that needs to be solved. In the context of financial reporting measurement this may be the case where:

- people are confronted with a measurement problem and do not know how to deal with it;
- worthwhile information that could be provided is not being provided;
- information that is being provided is not worthwhile or even has negative effects – for example, because it is misleading.

In deciding the future direction of change – or whether there should be any – there are two key choices to be made on consistency or diversity in the bases of measurement used in financial reporting:

- whether to require consistency for different items within an entity’s accounts;
- whether to require consistency across different types of entity.

The current situation and the options for change are represented in Figure 3, which shows options of diversity and consistency in the measurement of different items in accounts and options of diversity and consistency across entities. In the figure:

- the left quadrant shows the status quo position of diversity within accounts but consistency across entities;
- the top quadrant shows the option of consistency within accounts and across entities;
- the right quadrant shows the option of consistency within accounts but diversity across entities; and
- The bottom quadrant shows the option of diversity both within accounts and across entities.
It is conventional in studies on measurement to identify one basis as the best available for financial reporting purposes and to recommend that as far as possible it should be generally adopted. This would imply moving towards a solution in the top quadrant.

But it should not be assumed that every case of inconsistency in measurement is a problem that needs to be remedied. This report puts forward the following working hypotheses: that it may be appropriate in making decisions on measurement requirements:

• to adopt a mixed approach to measurement for different items in accounts; and
• to distinguish between different types of entity in accordance with their industry, ownership and governance structure, and size.

This would imply moving towards a solution in the bottom quadrant.

‘Evaluation of options’ should include the option to do nothing. Once the costs of potential changes (including the costs of making the change) have been taken into account and their likely benefits considered, it may become clear that the most sensible policy is to leave things as they are.

*Measurement in financial reporting* considers five principal measurement bases:

• historical cost;
• value to the business (also known as deprival value or current cost);
• fair value;
• realisable value; and
• value in use.

Of these, the last four are all forms of current value measurement. For each basis, the report discusses how it works and the reliability and relevance of the resulting measurements. While each basis has its strengths and uses, it is also true that for each there are legitimate doubts both as to its relevance for some purposes and its reliability in some circumstances.

*Measurement in financial reporting* recommends that standard-setters’ approach to measurement questions should be significantly more evidence-based than has typically been the case hitherto. To support an evidence-based approach, it suggests topics for research on measurement issues, including:

• the different users of measurement information and how they use it;
• what measurement information users regard as relevant and what they regard as reliable;
• owners’ use of measurement information in assessing managers’ stewardship of a business;
• the comparative usefulness of different measurement bases in helping to predict future cash flows;
• the costs of using and preparing information on different bases, including the costs of change;
• how different measurement methods affect financial stability and the wider economy; and
• the lessons of experience from earlier experiments with current value information.
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