IFRS

IASB Speech

Historical cost versus fair value measurement: les extrêmes se rejoignent

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Introduction

Mesdames et Messieurs, c'est avec plaisir que j'ouvre la conférence européenne de la Fondation IFRS, en cette belle ville de Paris. La date de cette conférence coïncide avec le dixième anniversaire de l'application des IFRS en Europe. C'etait une décision historique qui a réellement lancé le mouvement mondial d'adoption des IFRS. Je sais et j'apprécie que, tant le Parlement français que le Ministère de l'Économie et les instances responsables de l'information financière—la Commission des Opérations de Bourse, et le Conseil national de la Comptabilité—ont soutenu avec conviction ce projet européen d'adoption des normes comptables internationales.

Accounting history in France

Talking about history, I would advise everybody to read the book 'The Reckoning, Financial Accountability and the rise and fall of nations' by Jakob Soll[1]. This history of accounting through the centuries contains a fascinating chapter on public accountability in France just prior to the French Revolution.

The book describes how in 1777 King Louis XVI appointed the Swiss banker Jacques Necker as Minister of Finance. Necker's main job was to reform the tax collection system and to bolster the state coffers. In 1781 Necker took the revolutionary step of publishing a financial report of the state finances, which was called the Compte Rendu au Roi. He hoped that this unprecedented effort at transparency would improve the international credit status of the French state.

Unfortunately for Louis XVI, the Compte Rendu made painfully clear where the priorities of the French state lay. It showed that the costs of maintaining the Royal Court were equal to more than half of total military expenditures and that they were almost seven times higher than spending on roads and bridges.

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[1] Soll (2013), *The Reckoning: Financial Accountability and the Rise and Fall of Nations*, Basic Books, www.basicbooks.com

Not surprisingly, the Compte Rendu attracted a lot of attention, both in France and abroad. In 1781 alone, more than 100,000 copies were sold, a huge number for that time. It sowed one of the seeds of the French revolution, by exposing the extravagances of the absolute monarchy.

Necker was dismissed in May 1781, but public discussion on public finances continued. Public opinion forced Louis XVI to reinstate him in 1788. He was fired again on July 11, 1789, just three days before the outbreak of the revolution. But by then the ‘damage’ was done.

I would like to think that the spirit of Jacques Necker lives on in the work of the IASB. Our mission is to develop International Financial Reporting Standards that bring transparency, accountability and efficiency to financial markets around the world. Our work serves the public interest by fostering trust, growth and long-term financial stability in the global economy.

A Compte Rendu for the global age, if you like.

The measurement question

Talking about accounting and politics brings me to an important chapter in our recently published Exposure Draft for a new *Conceptual Framework*. It is the chapter on measurement, which is one of the most controversial and sensitive issues in accounting.

In our *Conceptual Framework*, we have divided the host of measurement techniques we use in accounting into two basic categories: historical cost on the one hand and current value on the other. Within the current value category, it is fair value accounting that generates most controversy.

Both historical cost and fair value have their fan clubs. The discussions between these camps tend to be heated and often ideological. They are therefore not always sufficiently based on fact.

So what are the facts? Fair value and historical cost are at the opposite ends of the measurement spectrum, with fair value demanding a full updating of all variables, while historical cost requires only partial and less regular updating.

The fans of historical cost like it for its alleged objectivity and relative stability. They dislike fair value for the volatility resulting from changes in market prices and for the subjectivity needed when fair values must be estimated, which is called mark-to-model valuations. They also tend to believe that fair value accounting is more prone to abuse because of its allegedly subjective character when relying on model-based measurement.

The fans of fair value like it for the very reason that it *does* require a full update of all inputs at each reporting date. They believe this gives the most meaningful picture of the financial position and performance of an entity. They recognise that fair value may lead to volatility in the income statement, but they believe that to be an accurate reflection of economic reality. They consider historical cost to be a very primitive measurement basis that provides information that very quickly becomes outdated.

Historical cost and fair value

Let me first explain why I think the dichotomy between historical cost and fair value is not as stark as one would expect.

First of all, for many transactions, historical cost starts and ends with fair value (or values that come very close to it): the original purchase price and the selling price of an asset or liability. The dates of purchase and sale are when historical cost is most objective.

Secondly, despite its name, historical cost gets updated too, albeit less than fair value. The most common updating of historical cost is depreciating Property, Plant and Equipment, or PPE. Depreciation is an allocation of cost to reflect the consumption of an asset during its economic life. This is an assessment that is certainly not free from subjectivity.

Subjectivity in historical cost accounting is even more pronounced when an asset is deemed to be impaired and an estimate of its value-in-use needs to be made. That estimate is based on management's estimates of future cash flows, which are certainly no less subjective than mark-to-model valuations. Because of this subjectivity, there is also room for abuse. Practice has shown many instances of 'big bath' impairments by new CEOs to bolster earnings in future years.

Thirdly, the alleged stability resulting from historical cost accounting can be extremely misleading. A classic example is the Savings and Loan, or S&L, crisis in the United States.

In the early Eighties, the S&L institutions were de facto bankrupted by a huge interest rate mismatch between their deposits and their outstanding loan portfolios. As Federal Reserve Chairman Paul Volcker increased interest rates dramatically, the S&L institutions had to pay a lot more interest on their deposits, while their interest income on long-term mortgages was largely fixed. Clearly, historical cost accounting did not show the full extent of the losses that were unavoidable. It gave a false portrayal of stability, which everybody knew to be untrue.

Finally, the stability of historical cost can be interrupted by steep cliff effects. Because measurement updates are less frequent and comprehensive, a creeping erosion of the balance sheet may remain unseen for a very long time. When problems finally erupt, they tend to do so with a vengeance. The stability of historical cost then turns into serious convulsions.

In conclusion, historical cost is to some extent based on fair value; it needs a degree of current measurement to maintain its relevance, it is not free from subjective updating requirements; and it is not necessarily stable. Moreover, historical cost is also vulnerable to abuse. In sum, all the vulnerabilities that are often attributed to fair value accounting can be equally pertinent to historic cost accounting. Les extrêmes se rejoignent…

Despite all these shortcomings of historical cost accounting, the IASB has not opted for current value measurement in general, or fair value in particular, as the default measurement basis.

For many economic activities, we are not convinced that using fair value for measurement would lead to relevant information. The main reason is that the current market price of many assets is not of primary importance if such assets are being used in combination with other assets to produce goods or services. For example, it may not be extremely relevant to know the present market value of the robots of a car manufacturer if the company intends to keep them to produce cars.

Moreover, if profit or loss were to include frequent adjustments resulting from revaluations of PPE, an entity's performance could be clouded. This is precisely why the IASB recently amended its *Agricultur*e Standard, IAS41. Previously, companies such as palm oil plantations or wineries were required to measure all their trees or vineyards at fair value, even though they are primarily used to produce palm oil and grapes, instead of being held for active trading.

These fluctuations in fair value were seen to muddy the income statement of such companies. Many felt that bearer plants such as palm trees should be treated in the same way as PPE. The IASB acknowledged these concerns and we ended up changing the measurement basis for these trees and vineyards from fair value to historical cost.

However, for assets that are actively traded, fair value tends to be much more relevant than historical cost. For example, financial instruments that are held for trading must be measured at fair value and this usually generates little controversy.

But it is not enough to just look at why and how an asset or liability is held and how it contributes to future cash flows. Equally important can be the characteristics of the asset or the liability, for example the sensitivity of its value to changes in market prices or to other risks that are inherent in the item. In the case of derivatives, for example, measurement at historical cost makes no sense even if those derivatives are not held for trading purposes. Derivatives often start out at zero historical cost and can be in and out of the money during their lifetime. They can switch back and forth between being an asset or a liability. Obviously, for derivatives the only measurement basis that makes sense is fair value.

Equally, historical cost is a highly deficient measurement basis for an insurance liability, especially when that liability has a long-term character, such as life insurance. The insurance liability is so sensitive to changes in the time value of money that a current measurement is clearly the only right answer.

The IASB is aware that fair value measurement can involve a high degree of subjectivity when there is no active market and the entity has to resort to mark-to-model valuations. However, despite a high degree of measurement uncertainty, in some situations fair value may still be the only measurement basis that can provide faithful representation. To limit the risks of such accounting, the IASB has developed extensive disclosure requirements in IFRS 13. This Standard requires entities to clearly disclose where they make use of mark-to-model accounting. It also requires sensitivity analyses where there is a high degree of outcome uncertainty.

Conclusion

In conclusion, I think the IASB was wise not to express a general preference for either historical cost on the one hand or for current measurement, or more specifically, fair value on the other hand. Instead, we acknowledge that in many cases mixed measurement is the expected outcome of our standard-setting. In our Exposure Draft we do, however, discuss the factors that the IASB will need to consider when it selects a measurement basis in particular cases. In my presentation I have tried to make clear high-level conclusions that might flow from that discussion:

- If the nature of business activities is to use assets in combination with other assets to produce goods or services, this generally points in the direction of historical cost.
- If the nature of business activities is to trade assets or liabilities in active markets, this would generally point in the direction of current value measurement.
- If the characteristics of an asset of a liability are such that they are highly sensitive to market factors or to other risks in the item, this would generally point in the direction of current value measurement.

These are very broad brushstrokes indeed, and in practice even more factors will need to be taken into consideration, such as the cost of performing the measurement, the degree of measurement uncertainty, faithful presentation and the avoidance of accounting mismatches. Setting accounting standards requires many complex decisions and therefore our *Conceptual Framework* provides few simple answers. I do believe, though, that our Exposure Draft will provide the basis for a fruitful exchange of ideas with our constituents around the world. Even if we cannot resolve all the difficult questions that have haunted standard-setters for the past decades, I am sure that the measurement material we propose to include in the *Conceptual Framework* will provide the IASB with a firmer foundation for making measurement decisions in future. We very much look forward to your feedback on our proposals.