7 Fixed Asset Measurement (I)

7.1 Introduction

The measurement of asset values for accounting purposes is inseparable from the determination of business income. Business income has been described earlier as the increase in owner’s wealth or owner’s interest over a period of time. Owner’s interest itself represents residual claims on the net assets of an organisation, i.e.

\[
\text{Business income} = \text{Owner’s interest}_{t_2} - \text{Owner’s interest}_{t_1}
\]

where

\[
\text{Owner’s Interest}_t = \text{Assets}_t - \text{Liabilities}_t
\]

Hence the determination of periodic business income is based on the values assigned to the assets and liabilities of the business. The accounting determination of income is not, however, normally undertaken through a process of valuation but through the allocation of the revenues earned and expenses incurred to each accounting period. Asset values are only indirectly included in an historic cost system of accounting. For example, the change in value of goods sold during an accounting period is recognised by crediting the Profit and Loss Account with the revenues received on sale of goods and debiting with the cost of acquiring, or manufacturing, those goods. The valuation or measurement of other assets (and liabilities) remaining in the business at the end of an accounting period has not yet been considered explicitly. The accounting treatment of fixed assets held but not disposed of by the end of an accounting period is the subject matter of Chapters 7 and 8, while the treatment of current assets is the subject matter of Chapters 9 and 10.

7.2 Asset valuation and accounting income

Introduction

Traditional accounting treatment of asset valuation differs markedly from that resulting from the application of economic theory. Although assets were
often recorded at market or other valuation prior to the mid-nineteenth century, for most of the last 80 to 100 years the accepted doctrine has been to record assets at original, i.e., historic, cost or lower. The practice of recording depreciation, although observable before 1900 was not itself accepted as sound accounting practice until after a number of judgements in legal cases in the early part of the twentieth century.¹

Accounting rules have developed along lines which are loosely identifiable with the idea of measuring income after ensuring the maintenance of the owner’s wealth. Wealth, or capital, maintenance was identified by reference to the monetary amount of capital invested by the owners, not the earnings capacity of the business. Similarly, assets were valued either by reference to the actual amount expended in their acquisition, or else the cost of goods given in exchange for them, or exhausted in their creation.

The reasons for the general acceptance of an historic cost basis of accounting have already been referred to in an earlier chapter. Two particular reasons are, however, worthy of re-examination, namely: (i) the desire for objectivity; and (ii) the overriding emphasis placed on conservatism.

Historic cost valuation satisfies the desire for objectivity in asset valuation, to the extent that the cost of acquisition is verifiable by reference to invoices, or other primary data sources. The element of objectivity is not normally present, however, in the case of those assets acquired in exchange for other assets, or those obtained through the exhaustion or conversion of existing assets, e.g., machinery produced by the firm for its own use. Additionally, whether an asset is acquired for cash or in any other way, the element of objectivity is no longer present when valuing assets in years subsequent to acquisition.

The doctrine of conservatism, similarly, may be satisfied by adherence to the historic cost valuation process, but it need not be in all circumstances. Non-recognition of higher replacement costs of assets may impair the future earnings capacity of a business and even the ability to repay debts incurred, and may eventually lead to business failure. Acceptance of a doctrine merely because it satisfies the requirements of objectivity and conservatism is insufficient; the doctrine must also satisfy the functions for which accounting statements are prepared. Recent discussion of the deficiencies of historic cost accounting in the business and academic world suggest that user needs may not be satisfied by continued adherence to the historic cost basis of asset measurement and income determination, particularly during periods of rapidly changing prices.

**The allocation problem**

The accountants’ notion of an asset has been compared by A. L. Thomas to the economists’ concept of an economic good, i.e., ‘goods that can be bought a.id sold in a market – goods that command a price’.²

The classification of economic goods used by Thomas and adopted in the following section, identifies two forms of economic goods:

- **Monetary goods** consisting either of cash or else legally enforceable claims to receive cash;
- **Non-monetary goods**, including all others.