**FINANCIAL ACCOUNTING**

Topic 6: Measurement Concepts

Reference: Stice, James D., Stice, Earl K., and Skousen, K. Fred (2007). Intermediate Accounting (16th ed.). Mason, OH: South-Western Cengage Learning. Used with permission from the publisher.

Five different measurement concepts are currently used in accounting:

**Historical Cost**

This is the cash equivalent price exchanged for goods or services at the date of acquisition. Examples of items measured at historical cost: land, buildings, equipment, and most inventory.

**Current Replacement Cost**

This is the cash equivalent price that would be exchanged currently to purchase or replace equivalent goods or services. Examples of items include some current inventories that have decline in value since acquisition.

**Current Market Value**

This is the cash equivalent price that could be obtained by selling an asset in an orderly liquidation liquidation. Examples of items include many financial instruments – stocks and bonds. This is sometimes referred to as “mark to market.”

**Net Realizable Value**

This is the amount of cash expected to be received from the conversion of assets in the normal course of business. An example includes accounts receivable. On the balance sheet accounts receivable are shown at gross amount billed less an estimated allowance for doubtful accounts. The result is expected net realizable value.

**Present (or Discounted) Value**

This is the amount of net future cash inflows or out-flows discounted to their present value at an appropriate rate of interest. Examples of items include long-term receivables, long term payables, and long-term operating assets determined to have suffered a permanent impairment in value.

On the date an asset is acquired, all five of these measure attributes have approximately the same value. The differences arise as the asset ages, business conditions change, and the original acquisition price becomes a less relevant measure of future economic benefits.

Current accounting practice in the United States is said to be based on historical costs, although, as discussed above, each of the five measurement attributes is used. Still, historical cost is the dominant measure and is used because of its high reliability/objectivity. Many users believe that current replacement costs or market values, though less reliable, are more relevant than historical costs for future-oriented decisions. This is a classic trade-off between relevance and reliability.