

# [Financial reporting techniques and methods](https://assignbuster.com/financial-reporting-techniques-and-methods/)

## Introduction

Over the course of the last few decades there has been considerable discussion and debate regarding financial reporting and, in particular, the appropriate measurement basis that should be implemented for use with a corporation’s financial statements. During this period international accounting standard bodies have been endeavouring to develop an agreed standard conceptual framework that is acceptable by all accounting regulatory bodies for use in financial statement, irrespective of the corporation and its country of domicile, and one that identifies the items to be included within the statements and the manner in which these should be measured (Johnson 2004). The intention is to avoid a situation where there are numerous differing standard of financial reporting in operation within the global market place (Bullen and Crook 2005, p. 5).

However, attempts to achieve this international consensus, specifically in terms of the measurement basis used, has not been universally accepted, with many divergence of views on the subject emerging from corporate management, the accounting profession and the users of financial statements. As the ICAEW (2006, p. 5), commented in their recent report, “ Current measurement practices are complex, diverse and apparently inconsistent. There is clearly at least a case for something more consistent and, presumably, simpler. ” The difficulty remains that arriving at such a simplistic resolution needs to address the fact that many elements of measurement within accounting processes are subject to judgment, convention and estimation (ICAEW 2006, p. 20).

The purpose of this paper is to analyse the various measurement basis currently in use and evaluate their advantages and disadvantages and, as a result of this analysis attempt to identify the areas that required further consideration prior to the requirements for measurements being embodied within a revised international conceptual framework. However, to provide some background on this issue, it is considered necessary to firstly understand the purpose of financial statements, in terms of those who use them and their needs to facilitate that usage.

## Users of Financial Statements

Whilst in terms of publicly quoted companies the main users are seen as management, investors and analysts, there are a number of other groups that use financial statements for a range of purposes. These include the business employees, its lenders and suppliers, governmental departments and, in some cases, members of the public (IFP 2006). Each of these groups have different needs which the financial statements need to address when considering the measurement base they are going to employ, dependent upon which group these reports are being targeted at.

In terms of investors, analysts and those generally involved with the global capital markets and stock exchanges, their need is for reliable and accurate information upon which they can base economic decisions (Gregoriou and Gaber p. 16 and p. 64). Furthermore it is important to this group that the monetary information provided reflects a current and fair value of the business and its relevant information. Governments and regulatory bodies have similar needs in relation to assessing the financial position and results of a business, in their case the purpose is to evaluation economic decisions such as potential taxation revenue from which they will be able to assess the state of the national economy and public spending levels.

Other users groups identified, which include employees, suppliers and lenders, approach financial statements in a slightly different manner, with their focus on using the financial statements to assess the corporations potential impact upon their lives and businesses. For example, a supplier or lender is unlikely to conduct business with a corporation whose financial statements show lack of liquidity or cash flow difficulties. Similarly, employees wish to assure themselves that a) their pensions are protected and b) that their employment is with a financially secure business. In other words their needs relate more to the physical tangible and immediately realisable assets such as cash, rather than less relevant “ fair value” aspects of the statements. However, historically management have been more reluctant to provide these groups with financial accounting data (Purdy 1978), although corporate governance regulations have eliminated much of their control over such matters.

Whilst there ate differing purposes for which these groups need financial statements, and they may value certain measurements bases more than others, as Johnson (2004) accurately stated, the basic need of all the users is wealth. Just as Investors and capital market players are looking to protect and increase their wealth, so to are governments, employees, lenders and suppliers.

In reality it is the user who is benefited by improvements in the quality of the reporting standards more than the company itself (Langendijk et al 2003, p. 194) and they need to be assured that the statements provided by corporations that they are involved with show an accurate and truthful position of the business that they can rely upon to make informed judgements relating to their individual needs.

## Measurement Bases for Financial Statements

Over the decades there have been a number of measurement bases used for financial reporting purposes and his reports focuses upon those that are considered the most important of these methods.

### Historical Cost

In the past the historical cost reporting method has been the predominant choice for financial reporting, favoured by many because it is more factually based and therefore considered to be “ more transparent ” (Langendijk et al 2003, p. 74 and p. 329).

The basis of historical cost measurement is that a monetary item can be identified by the actual price paid for an item purchased or received from an item sold, whether these relate to revenue and expenditure items or assets and liabilities. Therefore, if a business purchases an item of equipment for £10, 000, that is the fiscal amount that will appear within its balance sheet.

The historical cost measurement, whilst it takes into account the loss of value of an asset, for example by depreciating the value of a motor vehicle over its perceived useful life, does not take into account any potential increase in the value of an asset until the date the asset has been sold. Therefore, if the business owns a property, which is known generally to be an appreciating asset, under the historical cost method, this property will appear in the balance sheet at cost until it is subsequently sold. Therefore it is apparent that any true gain or loss made on such assets will not be accounted for until the time of sale.

Similarly, assets and liabilities that have no cost, such as internally developed software that can be sold, as they do not have a unit value will not appear as within the company’s financial statements using this method of measurement.

With regard to income, the purpose of the historical cost method is to link costs expended with revenue that is generated at the same time (ICAEW 2006, p. 23).

### Current Cost – Value to the Business

In essence current cost measurement, of value to the business, as it is sometimes known, is based upon the concept of “ physical capital maintenance ” (Gregoriou and Gaber 2006, p. 132). In other words as Gregoriou and Gaber (2006) state in the same passage “ a period’s income is positive only if the depreciation amount based on current cost is earned .”

The basic premise of this measurement is an attempt to calculate “ how much worse off a business would be if it were deprived of an asset ” (ICAEW 2006, p. 24). The reverse is also true in that with a liability it is necessary to ascertain how much better off a business would be if the said liability were removed from the business.

The core measurement in this case is predominantly based upon including within the financial statements the current replacement cost of the asset and to this extent, unlike the historical cost method it recognises the gain or loss to the business within the period of the statements rather than at some later date. Furthermore, the value to the business method takes into account the serviceable quality of the asset when comparing the asset held against the value of a replacement asset of the same specification.

Current cost measurement is designed to provide a measurement of opportunity cost of a business, which some researchers, such as Edwards et al (1987, p. 10) have regarded as the only correct manner to measure the true profit and capital.

### Realisable Value

IFP [1] (2006, p. 28) define net realisable value as the “ selling price of the item in the ordinary course of business. ” Although similar to the historical, current cost and fair value measurement methods in some respects, the realisable value method focuses upon the price at which an asset can be sold, or the cost at which a liability can be cleared.

The realisable value measurement also includes, in the majority of cases, the costs that are attached to that sale or settlement. Therefore it will record the net monetary result of the transaction, for example settlement of a liability will be shown as the cost of settling the debt and any costs that are incurred within that process, such as commissions or interest payable. Similarly, with assets the sale price reflected will be net of such costs as commissions and associated costs.

Realisable value is considered by some to reflect the value that might attach to a business in the event of a forced sale, for example in the case of liquidation. Others, such as the ISAB [2] (ISAB 2) view it as an “ entity-specific” form of measurement, which differentiates its focus from that of the fair-value method of measurement.

### Fair Value

The fair value measurement basis is perhaps the most difficult model to describe, although it is currently the method favoured by the majority of the international standards board. The primary target of this method “ extends to non-financial items” and is directed at the “ valuation of assets and liabilities in the balance sheet ” (Langendijk et al 2003, p. 22 and p. 108).

The ISAB (2006, p. 12) paper states, “ the objective of fair value measurement is to reflect the market value of an asset ” with the reporting statements. Where this is not possible, because such a market does not exist then an estimate should be used based on what would be considered to be the value if a market was available for the asset. Thus, when preparing the financial statements, if the fair value method is being used, it is incumbent upon the management and their auditors to seek and report independent valuations in respect of the assets and liabilities that will be recorded in the corporation’s balance sheet.

In practice therefore, fair value is based upon an exit value approach (ICAEW 2006, p. 29) to monetary recording, although the international standard regulatory body (ISAB) does allow for the use of other measurement methods where “ fair value” is not deemed feasible or appropriate.

In reality corporations have a tendency in practice to utilise a combination of the measurement bases depending upon the monetary item being recorded and the differences that occur in terms of their individual industry, business size and structure (ICAEW 2006, p. 3). Furthermore, as can be seen from the ICAEW (2006) discussion paper, there is an element of inter-relationship between them, which provides for additional complication.

## Advantages and Disadvantages

Generally it is agreed that, irrespective of the method of measurement used, all of the methods have a certain degree of uncertainty and the need for estimation, although the intention is for such estimations to be based on factual information available on the date the measurement takes place (ISAB 2006, p. 12). However, as outlined below, there are some significant advantages and disadvantages that attract to each of the measurement bases that are discussed within the previous section of this report.

One of the fundamental benefits of this measurement method is its conservative approach to financial reporting. This is beneficial in that: –

* It reduces the risk of unrealised future gains, which may not transpire, being distributed to shareholders in advance of the event, thereby protecting lenders and creditors.
* Reported profits are lower (IFP 2006, 310), which has taxation benefits in that tax is not payable upon income that has not been realised. Furthermore, management incentive schemes are unable to take advantage of profits shown though other methods that may not materialise.
* Less opportunity for use of inflated valuations.

Another advantage that attracts to historical cost is that it is more in tune with the information that the business managers use, and indeed their processes of financial recording systems and, for some users will be more relevant to the business and, as such is an objective measurement of values (IFP 2006 p. 33).

In terms of the inherent disadvantages of this method, some critics view its historical nature as being the major drawback because: –

* The information contained is out of date and therefore cannot be relied upon to give an accurate worth.
* The lack of value appreciation leads to an understating of the business worth and asset value.
* The difference between historical and current values is misleading for investors and analysts (ICAEW 2006, p. 8).

### Current Cost – Value to the Business

The major advantage that attracts to the current cost method is the relevance that it has to users of the information outside of the business management. By its nature this method provides: –

* Competitors with an idea of the costs of new entry to the specific corporations industry market place.
* Regulatory bodies can use the information to assess whether there is fairness being exercised in terms of competitive advantage.
* Potential investors are more able to ascertain the business operational capacity on an ongoing basis.

Furthermore, it is perceived by many observers that the relevance of each individual asset or liability being measured in this manner is advantageous because it provides a better overall view of the business.

The reverse view of this method is based upon a number of points, the main one being the fact that the purpose of management is the maintenance of profit and increase in shareholder value, and that this does not relate to the operating capital. It is more important in this respect to increase the wealth that stakeholders receive from their investment, by achieve better returns on resources, than it is to concentrate upon operating capital.

It is also considered that the rapid changes currently occurring within the market place and the pace of advancement in modern technologies negates the perceived advantages that potential new entrants gain from the this method.

### Realisable Value

Realisable value is attractive to some users, particularly investors and vendors, because of its accuracy in denoting and reflecting the net cash position from the realisation of an asset or liability. Therefore: –

* They are not misled into making decisions based upon monetary information that has not taken into account contractual costs attached to the sale or settlement of a balance sheet item.
* It becomes easier to ascertain the ongoing prospects of the business. For example, one can decide on the basis of realisable value, when a business is approaching a position of no longer being seen to be a going concern.

As with current cost and fair value, the disadvantages of this method are that it does not directly relate to the information that the business management uses on a regular basis and, additionally, it relies upon a degree of estimation that is calculated according to the judgement of the business advisors, which may or may not come to fruition in the amounts submitted. Thus the position indicated within the statements may not be sustainable (ICAEW 2006, p. 33).

There are many academics, economists and other observers who believe that fair value is the most appropriate measurement for use in financial account, but equally there are those who disagree with this view (Langendijk et al 2003, p. 52).

Those who support the fair value approach claim that it is beneficial to certain user groups, including investors and lenders in that its application to individual and separate assets and liabilities gives a number of benefits: –

* Provides a measure of the realisable value of the asset worth on disposal.
* More accurately identifies which assets could be sold without adversely affecting the business activity and future success.
* It saves the user considerable time, effort and cost in having to recalculate figures contained within other methods of valuation.

Those who disagree with this measurement state that it is irrelevant to the actual intention of the business management in that the fact that the item is included within the financial statements indicates that there was no intention to sell at that time. Similarly, those in disagreement argue that, in the majority of cases, separating assets in a sales situation produces a lower return for the business than a sale containing an amalgam of asset sales is likely to return. For example, the sale of a part of a business specific revenue asset would produce a lesser price than the sale of the total assets that contribute to that asset stream. Thus it has the effect of depreciating rather than enhancing shareholder and business value.

The other difficulty that is perceived to attach itself to fair value is the variety of ways in which it can be calculated and the various treatments that are used (ICAEW 2006, p. 9).

### Improvement to conceptual framework

Both of the major accounting standard boards, ISAB and FSAB [3] are aware that the existing conceptual framework for financial reporting requires improvement (Gregoriou and Gaber 2006, p. 101) and that it is important that the information that these produce relating to corporations is “ complete and free from error and bias ” (IFP 2006, p. 21). However, there are a number of areas that need to be investigated further to ensure that the revised conceptual framework envisaged is an improvement on the existing situation.

The most important of these is clarification of the information that needs to be included or omitted from the financial reports and, additionally, if inclusive how and where it should be presented (Bullen and Crook 2005, p. 13). At present the framework classification is not extensive enough to eradicate confusion. Furthermore, there remains at present some ambiguity in relation to the definition of the control and terminology with relation to “ assets” and “ liability” (Bullen and Crook 2005, p. 12). Similarly, a more constructive approach to the measurement bases needs to be taken. In this respect the conceptual framework needs to more precisely identify which measurements would be appropriate for each particular item that appears within the financial statements. Failure to address this leaves an element of uncertainty, which can be damaging for both business managers and those who use and rely upon the reports.

Additionally, in our opinion, there remains the problem of compatibility. There is no doubt that it is necessary to endeavour to achieve a standard of reporting that is acceptable to all of the business stakeholders, which includes the management and users who rely upon these statements. At present, as can be evidenced by the continuing debate on this subject, that harmony between the parties involved is not being met.

## Conclusion

From the research that has been conducted in the preparation of this paper, it is the opinion of the author that there is a need for a revision of the international conceptual framework. In addition, it is also considered that the measurement bases to be used within this need to be more clearly defined.

In the author’s opinion, one important and central point that it is felt necessary to take into account is that, in effect, all financial statements are historical at the time they are released. The rapidity of change that occurs within the market place and in new technology development means that factual, opinion based and estimated information contained within the financial statements is historical at the moment of publication. Therefore it is necessary to temper any improvements to the framework being considered against this premise.

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### Footnotes

[1] International Financial Publishing

[2] International Standards Accounting Board

[3] Federal Accounting Standard Board (US).