The measurement issues in financial reporting

As a key aspect of financial reporting, we can say that measurements of business financial position and, also, measurements of business performance have a certain disposition towards most of us, on one way or another.

How the capital is allocated within individual businesses and companies?

Is business regarded as a success or not?

What dividends investors receive?

Whether employees will earn a bonus, or can they keep their jobs?

How much tax does the business pay?

All these questions should be answered through the financial report.

Large corporations often adopt various asset valuation approaches. These include traditionally used historical cost, and among others, amortized historical cost, fair value, and also, value in use. Non-current assets are often acquired in different financial years. Their value will be simply added to give a total value in dollars even though the costs or valuations of these asses will provide limited reflection of their current value. In accordance with AASB 116 " Property, Plant and Equipment" it is acceptable for some classes of property, plants and equipment to be measured at cost, less a provision for depreciation while another class of property, plants and equipment can be measured at fair value. Then, values of differently measured property, plants and equipment are simply added together with the total presenting neither cost nor fair value.

With time passing by, standard-setters have favoured different measurement bases. From the beginning they favour the historical cost base to measure a firm's assets and liabilities, then in the 1960s and 1970s, they started to favour the current cost base because of the high inflation rates at that time, accounting standards required forms of current cost accounting were introduced in the US and UK in 1979 and 1980 respectively (Malcolm & Janice 2000, p. 4). But this experimentation on accounting measurement failed and in 1985 the UK standard-setters withdrew this standard. Now the standard-setters seem to favour a mixed measurement bases to measure the value of asset and liability and the other accounting elements such as profit. According to AASB standard, a firm's financial reports should provide useful information for external users to make decisions. Under this direction, in our research we try to find out which measurement base is more likely to be used to measure a firm's assets, liabilities and equity etc.

Key Objectives

Every time we talk about the key aspects of financial reporting, we will end up with measurement. Because there are different accounting theories which use different measurement bases, if there is not some general measurement standards, those financial reports will be meaningless and won't provide relevant & reliable information to users. For example, we use historical cost basis to get the value of an asset, exit price for the other assets and prevent value for the liabilities, then we add up the figures into the balance sheet, this balance sheet is irrelevant, unreliable and misled; it can not fulfil the decision usefulness objectives of financial reports. In this paper we will try to give some explanations on how standard setters approach measurement, what are commonly considered measurement bases, and how our research can contribute in efforts to resolve issues related to measurement.

Theoretical Perspectives

For accounting purposes, when we use the word “ measurement”, it means we want to measure the value of each asset, liability etc such as historical cost. For many years, accountants have argued about which value is most informative for financial report users. Some claim that we need to ascertain the firm’s objectives and from this infer the kind of monetary value that will best inform users about the firm while others propose that measurement should reflect the risk borne by investors and lenders to the entity(Godfrey et al. 2006). In this paper, we will explain three kinds of measurement bases that are used today, which are historical cost, net realisable value and fair value.

Net realisable value method uses exit price to measure the value of asset, it subtract the cost of sale from expected selling price to get the amount. Because of the weaknesses of historical cost method, some accountants suggest that we should use exit price to replace historical cost, they believe this method can provide better information for decision making to the users. This method refers to the amount of cash or cash equivalent that would be obtained if the asset is sold currently. It reports all operating profits and holding gains and losses in the period which they occur and excludes the operating profits and holding gains and losses in the previous period so that it can eliminate the timing error. It also provides the relevant information of the current value and portrays the firm’s adaptability. By using the exit price base, the valuation of all elements in the balance sheet and income statement are at their money equivalents, therefore, they can be added up and the balance sheet can provide relative reliable information. However, like historical cost method, this method also has weaknesses which make it not particularly useful for decision making. It does not particularly concern the operation of the firm but instead concerns price change of assets and liabilities; therefore it is hard to evaluate the firm’s performance and efficiency because it concentrates on the financial liquidity and short-term decision making. Besides this, the financial position might deem to be no value if the asset can not be sold separately. Moreover, if an asset is retained instead of selling, its value in use is more likely greater than the current exit price. Finally, some intangible assets such as goodwill would be assessed as no value because they don’t have net selling price. All of the above weaknesses can dramatically decrease the reliability of the financial information.

The term ‘ fair value’ is defined in Australian Guidance which can be found in Accounting Handbook (but is not part of AASB 116) states “ it is the most advantageous price reasonably obtainable by the seller and the most advantageous price reasonable obtained by the buyer” (Accounting Handbook, 2006, p. 482). In determining the fair value of an asset, the asset has to be traded in adequate period of marketing to acquire its most advantageous price (Accounting Handbook, 2006). “ The fair value of an asset is determined by reference to its highest and best use, that is, the use of the asset that is psychically possible, legally permissible, financially feasible, and which results in the highest value.” (Accounting Handbook, 2006, p. 482). An entity checks at each reporting date if there is any showings that revalued asset’s carrying amount may significantly differ from that which would be determined if the asset were revalued at the reporting date (Accounting Handbook, 2006). If any such indication exists, than the entity would determine asset’s fair value and do the revaluation of an asset to that amount (Accounting Handbook, 2006).

As there were much criticism of historical cost accounting during the period of the 1970s and 1980s, also there were many supporters of historical cost accounting (Deegan, 2009). The method of accounting used today is still based on historical cost accounting, however some recent accounting standards have introduced element of current value or fair value measurements (Deegan, 2009). IAS 16/ AASB 116 allows reporting entity to choose between the “ cost model” (measuring property, plant and equipment at historical cost) and the “ fair value model” for measuring classes of property, plant and equipment (Deegan, 2009). Fair value model refers to the revaluation of the asset to its fair value (which means that revised form of historical cost accounting may be used) which is one way to take account of changing values (Deegan, 2009). In relation to the treatment of changing prices, Deegan considered IAS 41 (AASB 141 within Australia) (2009). IAS 41 refers to the measurements rules for biological assets (for example, grapevines or cattle) (Deegan, 2009). Changes in the fair value of biological assets from period to period should be treated as part of the period’s profit or loss as required from the accounting standard (Deegan, 2009). Regarding the development of the accounting standards some researchers were arguing that the increase in fair value related to changing prices should be distinguished from changes in fair value as a consequence of physical changes (Deegan, 2009). The main issue they were arguing was that only the physical changes should be treated as part of profit or loss (Deegan, 2009). In spite of the fact that IAS 41 treats the total change in fair value as part of income, it is also important to note that IAS 41 supports disclosures that distinguish among changes in the fair values of the biological assets are based upon price changes and those based on physical changes (Deegan, 2009).

On the authority of paragraphs 5. 1. 6 to 5. 1. 10 of AASB 1041 the fair value can be in general specified 1) by reference to transactions for the same assets, 2) by reference to transactions for similar assets, or 3) by calculation of the present value of the net cash inflows expected (Godfrey, Hodgson & Holmes, 2006). The fundamental principle stated in the standard is to determine a suitable fair value and the standard provides significant discretion, even with regard to the frequency of revaluation (Godfrey et al., 2006). The value should be reassessed in the accounting period in which the change take place if there are major changes in fair value (Godfrey et al., 2006). If there is no significant change, then no adjustment is needed, or the values can be indexed, but the standard requires that an official revision will take place every three years (Godfrey et al., 2006). The standard also approve that once the fair value method is selected, an entity may change back to cost basis, or simply stop to reassess the fair value of assets (Godfrey et al., 2006). In spite of that, the main issue is that the cost basis is the foundation for the adoption of and support for the historical cost method by the Australian accounting approach and the standard setting body (Godfrey et al., 2006). Where fair values refer to some groups of assets and not to others, AASB authorises entities to have a mixed approach (Godfrey et al., 2006). On top of that, the specification of fair value is relatively broadly determined and permits for various methods of valuation, both between classes of asset and over time (Godfrey et al., 2006). AASB presents the choice of current value accounting although the definition of an asset has been determined, which is in conflict with many other accounting standards and the historical cost model with its fundamental criterion of objectivity (Godfrey et al., 2006). It is clear that policy makers are willing to shift to alternative measurements methods, regardless of the failure to develop SAC 5 ‘ Measurements of the Elements of Financial Statements” (Godfrey et al., 2006).

Research method

We use the secondary data which published in the website, textbook and journal to perform our research.

Research findings

In our research we have found that much of the thinking of standard-setters about measurement seems to be based on an idealized view of markets as complete and in perfectly competitive equilibrium. There is a unique market price such as fair value for every asset and liability, so this price can be used as a single measurement base. It explains why the standard-setters try to introduce single measurement method because a single method can provide consistency with accounts and improves comparability across entity. But in reality, markets are imperfect and incomplete, So standard-setters use the same approach to measurement issues as they approach other standard-setting issues and questions. That is, they will attempt to apply all the recommendations and methods contained in their conceptual framework. In accordance with recent activities of the IASB and AASB it is clear that the use of historical cost is likely to be lower, and use of fair value or a mixture of measurement methods is going to increase. When boards have debated different measurement bases, the conclusion was that fair value in the best manner meets the conceptual framework criteria rather than other measurement bases that have been considered if single method approach is used. However, changes in accounting measurement to fair value are not applicable for all assets and liabilities. Some other measurement bases also have characteristics and will be considered to remain a part of the standards.

Limitation of the research/further research

Because we perform the research based on the secondary data gathered in different resource, the level and the exactness of findings are limited. We also have not used experimental method to check the findings. Further research uses other method such as survey is recommended to test the findings.