

# Challenges to the Users of Financial Reports Constructed Using Multiple Measurement Bases: A Review of the IASB's Conceptual Framework for Financial Reporting

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Received: October 4, 2017      Accepted: October 30, 2017      Published: December 8, 2017

doi:10.5296/ijافر.v7i2.11952

URL: <https://doi.org/10.5296/ijافر.v7i2.11952>

## Abstract

The IASB's conceptual framework for financial reporting identifies multiple measurement bases and concludes that an entity may employ more than one measurement base in constructing the financial reports. The framework further clarify situations as to how the preparers will proceed in constructing the entity's financial report where the preparers are satisfied that a piece of information is relevant to the users of financial reports, but is subject to a high degree of measurement uncertainty. The purpose of this paper is to critically evaluate the choice of multiple measurement bases in the conceptual framework and highlight the challenges posed to a user of financial reports who seeks to obtain insights into an entity's financial performance and position through reading reports constructed using an eclectic approach to measurement.

**Keywords:** measurement uncertainty, measurement base, fair value, recoverable amount, recognition

## 1. Introduction

Pandora's Box has much to offer; so does the International Accounting Standards Board (IASB). The revising of the IASB's conceptual framework was initiated in 2004 (IASB, 2015a). Clear objectives are helpful in many ways however, "this is most important, for one cannot develop a product without understanding who the customer is" (Penman, 2013, p.8).

One of the objectives of the conceptual framework is to, “assist preparers to develop consistent accounting policies when no standard applies to a particular transaction or event, or when a standard allows a choice of accounting policy” (IASB, 2015b, p. 21). To further add on this point, the conceptual framework assists standard setters to develop standards on “consistent concepts” (IASB, 2015b, p.21).

The use of a particular measurement base is dependent on the concept of relevance and faithfulness. On this, Gordon et al (2015) state that “when the information feature between recognized and disclosed amount are similar (there are no ‘rational differences’), financial statement users may perceive the recognised and disclosed information more similarly” (p. 77). In relation to this, the measurement base(s) that is going to be applied by the entities need to be the most relevant and faithful representation of the economic reality. The criteria in choosing the measurement base should depict the actual performance of the entity and the true effort made by the management. Therefore in this context; the choices of the measurement base are benefitting the users.

However, if we agree that for some assets and liabilities, the market value measurement provides the best information to the users then “evidence indicates that multiple markets with different prices do exist for some assets and liabilities” (AASB, 2006, p. 9). In these situations, which market value for the assets and liabilities to be applied and disclosed in the financial report while taking into account relevance and faithful representation of the information? Has the entity chosen the best value to reflect the economic reality of the item? Public interest vs. self interest is at stake.

Under IAS 36, fair values of asset are easily measured if an active market exists for the assets. However in the absence of an active market, professional judgment is required to estimate the recoverable amount. Will such information be disclosed truly by the preparers if their rewards for bonuses are dependent on meeting the target profits? Indisputably, the application of professional judgement will fail if the recoverable amount was less than the carrying amount of asset(s). Certain measurement bases provide the most relevant measure for an item even when there is high level of uncertainties about the future expectation.

However such measurement bases will lose it relevance if the uncertainties are expected to be low and it tend up to be high. In such cases, choosing such base did not worked to be a faithful representation of the reality, resulting the users of the financial report finding difficulty in their decision making process. Thus the purpose of this paper is to critically evaluate the choice of multiple measurement bases in the conceptual framework and highlight the challenges posed to a user of financial reports who seeks to obtain insights into an entity’s financial performance and position through reading reports constructed using an eclectic approach to measurement.

## **2. Measurement Base**

An inappropriate measurement base may be selected due to management’s self interest or the high cost involved under the appropriate measurement base. In such scenarios, the objective of IASB in providing the choices in measurement bases has been applied wrongly by the

preparers of the financial report and the entity's true and fair view has not been reflected for user analysis. On this, Gordon et al (2015) proposes that additional consideration should be given by IASB, "to the view that the relevance of a particular measurement depends on the manner in which investors, creditors, and other lenders are likely to assess how an asset or a liability will contribute to future cash flows" (p.74).

On the other hand, IASB (2015b) argues "sometimes, more than one measurement basis is needed to provide relevant information about an asset, liability, income or expenses" (p.71). According to IASB (2015b), the common way of using two measurement bases for the same item is "to use a single measurement basis for the asset or liability both in the statements of financial position and for the related income and expenses in the statement(s) of financial performance" (p.71) and then to "disclose in the notes to the financial statements additional information using the other measurement basis" (p.71). If both measurement bases provide relevant information then how the preparers did concluded which base to be included in the face of the financial statements and the other as in the notes to the financial report.

However, International Accounting Standards Board illuminates a way that is so not common but is a possibility. IASB (2015b) elaborated that "in some cases, because of the way in which an asset or a liability contributes to future cash flows (which depends in part on the nature of the business activities conducted by the entity) or because of the characteristics of the asset or the liability, the information provided in the statement of financial position and the statement(s) of financial performances is made more relevant by using: (a) a current value measurement basis for the asset or the liability in the statement of financial position; and (b) a different measurement basis to determine the related income or expenses in the statement of profit or loss" (p.84).

Nonetheless, when the preparers apply the concept of relevance then they need to understand that the financial statements should provide sufficient information to the users and not to provide too many information that they get confused on its applicability and usability. The financial statements should provide information to the users that they can understand. By preparing the financial reports with mixed measurement basis may lose its relevance if it is not done in an orderly manner. For example, if the entity is using 'historical cost' assumption and is only applying 'fair value accounting' to 'property plant and equipment' class of assets, then such measurement base need to be applied on the entire class of assets as outline by the appropriate standard. However, application of multiple measurement bases on the face of the financial statements may lose its relevance if preparers apply such base that will lead to improve their interest in the entity than the entity's true view.

### **3. Measurement Uncertainty**

Information is relevant if it is provided on time. The other "factor affecting the relevance of financial information is the level of measurement uncertainty" (IASB, 2015b, p.28). Further on this the IASB stated that, "the use of estimates is an essential part of the preparation of the financial information and does not necessary undermine its relevance, but the estimate needs to be properly described and disclosed" (IASB, 2015b, p.28).

The high level of measurement uncertainty may not result the information to lose its relevance however it may not be true if the expectation was that the information will be subject to low level of measurement uncertainty and it tends to be high. Thus, it indicates that the information needs to be relevant and at the same time it has to be a faithful representation of the phenomena. IASB (2015b) emphasized that, “an estimate can be faithfully represented if the reporting entity has properly applied an appropriate process, properly describe the estimate and explained any uncertainties that significantly affect the estimates” (p.30). Furthermore, Gordon et al (2015) states that “displaying estimates and assumptions to facilitate the assessment of measurement uncertainty ensures that the financial statements and notes reflect the qualitative characteristic of faithful representation” (p.96).

An essence of relevance with faithful representation and measurement uncertainty could be applied on impairment testing of a cash generating unit (CGU). Under IAS 36, the carrying amount of the CGU is compared with the recoverable amount whereby the recoverable amount is the higher of fair value less cost to sell (FVLCS) or value in use (VIU). Assume the entity projected that the VIU of the CGU is less than the carrying amount and concluded that the CGU is impaired without calculating the FVLCS due to measurement uncertainty. In this context the accounting standards’ application has not been properly applied plus by predicting the FVLCS, it will provide higher assurances if the CGU been impaired.

The application of IAS 37 enriches further on information with measurement uncertainty as it adds credibility to the financial reports. For instance, the probability of losing a lawsuit filed against the entity is 15%; IAS 37 requires the recognition of the contingent liability.

#### **4. Recognition**

International Accounting Standards Board recognizes ‘only items’ in the statement of financial position that meet the definition criteria of an assets, liability or equity. However the Board reasons that, “the purpose of the financial statements is not to show the value of the entity and therefore not all assets and liabilities are recognised” (IASB, 2015b, p. 34). The rationalization that is provided by the IASB for not recognising all assets and liabilities is that, “some items that meet the definition of an element can provide information that is not useful” (IASB, 2015b, p. 52). IASB further specified that an entity recognises an asset or liability if such recognition will provide users of the financial statements with ‘relevant information’, ‘faithful representation’ and “information that results in benefits exceeding the cost of providing that information” (IASB, 2015b, p. 52).

For instance, an entity purchased stationeries worth \$1000 for office use. These stationeries will be used by the entity for many financial periods and thus meets the definition of an asset. However, by applying the concept of materiality, such amount is immaterial to be recognised as an asset and be disclosed in the Statement of Financial Position over the periods. In such case it is better off to be recognised as an expense. This surely makes sense.

Further to this, IASB (2015b) elaborated that “judgement is required when deciding whether to recognise an item and recognition requirements may need to vary between standards” (p.52). However “if an item meeting the definition of an element is not recognised, disclosures may be needed” (IASB, 2015b, p.52). This point emphasize that if an item is not

recognised on the face of the financial statements then appropriate disclosure is required in the notes to the financial report. On the other hand, IASB stipulate factors whereby the items recognition may not provide relevant information.

Such factors are,

(a) if it is uncertain whether an asset exist or is separable from goodwill or whether a liability exist; (b) if an asset or a liability exists, but there is only a low probability than an inflow or outflow of economic benefits will result and (c), if a measurement of an asset or a liability is available (or can be obtained), but the level of measurement uncertainty is so high that the resulting information has little relevance and no other relevant measure is available or can be obtained (IASB, 2015b, p.53).

In these circumstances, IASB's justification is appropriate not to recognise all the assets and liabilities on the face of the financial statements. However, on the contrary, such option may be applied by the preparers of the reports far away from its' objective.

The faithful representation of an element involves "not only recognition, but also the measurement, presentation and disclosure of information about the items recognised" (IASB, 2015b, p.52). IASB (2015b) provides further insight that in order for the recognition of the asset or liability on the face of the statement of financial position in order to provide faithful representation is not only based on its description and measurement but also on the depiction of resulting income, expenses or equity, whether related assets and liabilities are recognised and full disclosures for the financial statement users (p. 54 – 55).

For instance, an entity recorded inventory worth \$500,000 at the commencement of the financial year. External indicators point out that these inventories will be out of market in the current accounting period. With reference to IAS 2, the year-end carrying amount for the inventory is \$450,000 and the realised value is zero. Applying faithful representation, the entity will recognise an expense account for the loss of the inventory. However the application of such by the preparers is doubtful.

## **5. Final Remarks**

The level of disclosure quality in the financial reports will be questionable where the financial reports are prepared on multiple measurement bases. Users will be sceptic if sufficient relevant information has been disclosed in the financial reports on the basis of using the measurement base. Furthermore, comparing performances between entities will be inappropriate if multiple measurement bases have been used without consistency to prepare their financial reports.

The users normally perceived recognise and disclosed information more similarly when there exist no rational differences. However, the conceptual framework offers provision for more than one measurement base to be used to provide relevant information by using a different measurement base for the financial statements' items and another measurement base as the notes to the financial report. Users will be perplexed if both measurement bases provide relevant information, how did the preparers concluded to which measurement base be applied on the face of the financial statements and the other to the notes of the financial report?

Further to this, preparers need to be careful in applying mixed measurement bases as it may decrease users' application and understanding.

The selection of a particular measurement base should reflect the relevance and faithful representation of the information for such item which will help users in their decision making process. The validity of estimates under uncertainty creates challenges for the users on its reliability. For instance in the absence of an active market "management needs to rely on estimates and judgements to determine the fair value" (Scott, Wingard and Biljon, 2016, p.142). As such, the preparers are empowered to apply the choice of multiple measurement base allowed in the conceptual framework that will reflect better perception of their performance which may not depict the true position of the entity.

Therefore, the IASB should further consider the opinion of the users in terms of how they value a particular measurement bases' relevance and faithful representation. Due to the choice in measurement base allowed in the conceptual framework, users' decision making is affected in situation whereby they expected a particular measurement base will be of higher relevance measure and it turn out to be low or preparers applied an inappropriate measurement base.

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