

# Issues in Financial Reporting Measurement at the Beginning of the 21<sup>st</sup> Century<sup>#</sup>

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The measurement provisions in existing US GAAP's<sup>1</sup> and IFRS's<sup>2</sup> Conceptual Framework and Standards are bounded, inconsistent and being treated unsatisfactorily. Both frameworks cover this topic in several paragraphs only.

The IASB Framework, for instance, simply lists examples of measurement bases and measurement techniques that are currently used in financial statements. Neither concept of measurement nor criteria of choosing among them when measurement requirements for a standard are determined is analysed. Thus, when applying the Framework to measurement questions, IASB focuses on determining which measurement base meets the objectives of financial reporting and the qualitative characteristics of accounting information in the best manner.

Similarly, the FASB Conceptual framework (SFAC 5) only describes the bases used in present practice without an analysis of the advantages and disadvantages of each base and without criteria for selecting among them. The main reason of this situation is that fundamental measurement issues remained unsolved for a long time, though measurement is a key aspect of financial accounting and reporting.

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<sup>1</sup> U.S.A. Generally Accepted Accounting Principles – regulation of financial reporting promulgated by the Financial Accounting Standards Board (*FASB*).

<sup>2</sup> International Financial Accounting Standards promulgated by the International Accounting Standards Board (*IASB*).

## **1 IASB Measurement Project in Standard-setting**

In November 2005, the IASB published Discussion Paper (DP) Measurement Financial Accounting – Measurement on Initial Recognition, prepared by the Canadian Accounting Standards Board (AcSB). This DP undertakes a preliminary research of possible measurement bases for assets and liabilities that are initially recognized in financial statements. It does not consider when assets and liabilities should be recognized in accounting primordially or when a re-measurement should take place. This research represents the first step of a long-term project and will proceed in several later stages, which will analyse subsequent issues.

The combination of history and ad hoc regulation by a few generations of standard setters has resulted in the “mixed bag” of measurement bases used today. The DP proposes following possible bases for initial recognition in IFRS: historical cost, current cost (of assets, defined as reproduction cost and replacement cost), net realisable value (of an asset), value in use (of an asset), fair value and deprival value (value to the business).

Discussion Paper analyses possible bases against criteria derived from existing IASB Framework (such as relevance, reliability, comparability and understandability) and presents their definitions. DP concludes that fair value is more relevant than the other measurement bases and should be used provided it can be measured with a sufficient reliability. Comments on the DP were submitted by May 19, 2006. After their analysis by the staff of AcSB and after debate of possible suggestions and adjustments they could be taken into account in IASB Framework.

The FASB have met with IASB in October 2006 (FASB, 2006). The main topic of the joint meeting was the analysis of Comment Letters Summary to IASB Discussion Paper.<sup>3</sup> The objective of this analysis was to provide insight into IASB/FASB joint conceptual framework project (see below), specifically the measurement bases, in connection with objectives and qualitative characteristics of financial statements. Analysis indicated that respondents interpret and apply the terms relevance and reliability in different ways. Boards (both IASB and FASB) agreed that they should clarify these concepts and give a guidance how the concepts

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<sup>3</sup> IASB obtained 187 Comment Letters to this Discussion Paper.

are to be applied in order to develop a common understanding and comparability.

The similar problem is the conception of fair value. Concerning the interpretation of what fair value purports to represent, many respondents see it differently. Some respondents agree with market value as the objective base, other disagree what should be accepted to represent fair value. Few respondents demur market forces to determine an impartial and comparable fair value and recommend an entity-specific perspective to determine fair value, which would include management expectations about an asset or liability. Many respondents disagree with the proposed market definition and focus on the question whether an equilibrium price for an asset or liability do exist in the real world. They believe, that it would be beneficial for users to analyse the measured assets and liabilities from the position of management. Moreover, many respondents believe that an asset used in the production of goods or services or acquired for resale should be recognized at historical cost. Majority of respondents request further guidance regarding which market is to be referred to when determining a fair value.

## **2 IASB/FASB joint Measurement Project**

In September 2002, IASB and FASB (the Boards) acknowledged their commitment to development of high quality and compatible accounting standards that could be used for cross-border financial reporting. They pledged to use their best efforts:

- a) to make existing framework and standards compatible (as much as possible) and financial statements comparable and
- b) to co-ordinate their future work programs to ensure that once achieved, the comparability will continue also in future.

### **2.1 Measurement research in Conceptual Framework Project**

At corporate meetings in 2005, the Boards reaffirmed their commitment of the convergence of US GAAP and IFRS. The product of their collective long-term strategic work will be a common set of high quality global standards. One of their common research intent is called **(joint) Conceptual Framework Project**. Its main goal is to improve the

existing frameworks of both Boards and to provide a sound foundation for developing future accounting standards. The project has eight phases, shown in Table 1.

**Tab. 1: IASB/FASB Conceptual Framework Project: Conduct and Status**

Project Phases, Status, and Timing			Next Document
Phase	Topic	Current Status	2007 + beyond
A	Objectives and qualitative characteristics	DP Comment Analysis to Boards – February 2007	ED Q3 2007 (estimated)
B	Elements and recognition	Board deliberations	DP Q4 2007 (estimated)
C	Measurement	Planning and staff research	Roundtables Q1 2007
D	Reporting entity	Board deliberations	DP Q2 2007 (estimated)
E	Presentation and disclosure, including financial reporting boundaries	Research by others underway	TBD
F	Framework purpose and status in GAAP hierarchy	Planning and staff research	TBD
G	Application to the non-profit sector	–	TBD
H	Remaining Issues	–	TBD

Notes: DP =Discussion Paper, ED = Exposure Draft, Q = Quarter, TBD to be determined

Data source: <[http://www.fasb.org/project/cf\\_other\\_meetings.shtml](http://www.fasb.org/project/cf_other_meetings.shtml)>.

Due process steps:

- **Phase A:** In February 2007, the Boards commenced their consideration of comments received from respondents on the Discussion paper *Preliminary Views on an improved Conceptual*

*Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information* that was published on July 2006. The Boards plan to issue an Exposure Draft at 3<sup>th</sup> quarter of 2007.

- **Other phases:** The Boards expect to publish Discussion Papers to seek comments on the Boards preliminary views arising from each phase that will be followed by Exposure Drafts.

## **2.2 Goal of the Measurement Phase**

As shown, the present joint IASB/FASB conceptual framework project includes a separate phase on measurement aimed at developing concepts relating to measurement in financial reporting. The goal of measurement phase is to fill the void of current frameworks that have no conceptual guidance on accounting measurement, providing only a short survey of measurement bases. This goal will be achieved by means of listing and analysing the various measurement bases in the current and proposed mixed-attribute accounting model.

In contrast to IASB's Discussion Paper mentioned above, the measurement project included in joint conceptual framework project does not focus on any particular measurement base, though some members of Boards are persuaded about advantageousness of fair value measurement basis. The measurement phase of the conceptual framework project has three stages called "milestones".

*Milestone I* focuses on measurement bases. Its purpose is to develop and integrate common accounting language by means of identifying, defining and describing the measurement bases currently used as well as those that have been proposed to date. This stage of research is currently under way and is expected to be complete by mid-2007. This phase would give answers especially to the following set of questions:

- What are the candidates of measurement bases and how are they defined?
- Are the measurement bases appropriate for both assets and liabilities?
- How does each base relate to prices and values, the building blocks of economic decision?

- Are there any measurement bases candidates that should be eliminated from consideration for evaluation in next research phase?

**Milestone II** will evaluate the candidate measurement bases in terms of the qualitative characteristic of decision-useful information discussed in the initial phase of joint conceptual framework project and of any other relevant criteria that could be identified later. It would give answers to the following set of questions:

- Can the measurement bases be used to create faithful representations of assets and liabilities that can be verified?
- Are the measurement bases relevant to economic resource allocation decisions?
- Would usage the measurement bases contribute to comparability and comprehensibility?
- Are there any other concepts in addition to the qualitative characteristics that should be used to evaluate the measurement bases?

**Milestone III** will draw conceptual conclusions from the evaluation results of milestone I and especially of milestone II and address practical issues of using those measurement bases that were rated as the most supreme in the milestone II. Also all other miscellaneous issues not treated in the previous stages could be discussed in the final milestone, especially:

- Could different bases be used for different purposes (for example, initial versus subsequent measurement, different types of assets or liabilities)?
- Should one measurement base (for example fair value) be used for all different purposes?
- What are the practical problems of using the selected base/bases? Should the problems preclude their use in some or all situations?
- Should the same base/bases used for financial statements also be used for other aspects of financial reporting, or could different bases be used outside the financial statements?

Once the measurement phase of the joint conceptual framework project is complete, the standard setters will finally have a high-quality measurement tool for improving measurement guidance. In this context,

some professionals asked question about relationship between standard setting and the measurement phase.

It is important to say that the whole conception project of framework is independent of any standard-setting process and vice versa, though both processes may influence each other. Joint IASB/FASB project is a research project and its main goal is to establish broad minds, ideas and concepts that might lead to a new paradigm. During the measurement phase, the Boards will continue to work on their standards as in the past, publishing preliminary views, discussion papers, exposure drafts and final standards.

### **3 Issues in Financial Reporting Measurement**

In daily life, measurements are typically derived from characteristics of physical objects – such as weight, height, length and so on. If measurement tools are accurate, the information is considered objective and uncontroversial. The subject of measurement in financial reporting, however, are abstract concepts of such quantities as income, revenue, expense, profit, gain, loss, net income, capital maintenance and so on.

#### **3.1 Measurement as a matter of convention and judgments**

All measurements needed are expressed in monetary terms and therefore the claims are to be expressed in some “value”, but what it is? This term is not defined for accounting measurement precisely and is used in various coherences at research, in standards and on practice. Standards setters and accountants have developed many different ways to measure the same elements and events, since different roles of assets and liabilities in business economy and their different attributes may give different values. Financial reporting measurement will always face difficulties because it is catching a continuous process of business activity at a particular moment (in the balance sheet) or between two particular moments (as in income statement), to express them in monetary terms by means of an arbitrary rather than exact process.

#### **3.2 Miscommunication**

As was formerly noted, the long-term national regulation processes (realised by a set of national standard setters generations, as well as by the

– in several decades expansive – international regulation of what we now label as “financial accounting” and “financial reporting”) has resulted in the “mixed bag” of measurement bases we use today. That is why measurement bases project in *Milestone I* is focused on measurement bases. Its main goal is to improve the common language we currently use.

In various jurisdictions, research, standards (including IFRS and US GAAP) and practices, same terms have been used for several not fully identical measurement bases (to refer to more than one measurement base), and on the contrary, various terms are used to express one measurement base. That is why discussions about measurement by means of round tables, comment letters and other professional sources are full of misunderstandings and why they never produced a consensus. There are at least two reasons why existing research and practice reached no generally acceptable effects. The first reason lies in miscommunication, the second one consists in a rushed classification leading to oversimplification.

For example: the term of “historical cost” is sometimes assumed to be the amount before any adjustments (for amortisation, depreciation, impairment and so on). On other hand historical cost measurement often requires the attribution of costs to asset or liability. Costs often must be allocated amongst assets, liabilities, and expenses. Such attributions and adjustment are likely to be subject to one-to-many or many-to-many allocation indeterminacy<sup>4</sup> and lead to various modifications of historical cost.

As precise terms are useful, it is necessary to analyse and determine different types of “historical cost”. If any amount is intended to include certain attribution or/and adjustment, the precise description of such “modified historical cost” (or “mixed measurement historical cost bases”) is helpful. This description may be depicted by means of various disunited synonyms, as illustrates Table 2.

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<sup>4</sup> The examples can be: unresolved (and irresolvable) debates on overhead allocations to inventories, mining and oil exploration properties. “Basket” purchase transactions; self-constructed assets.



**Tab. 2: Terminology dissonance: illustration on current synonyms of “historical cost” (past price/value measurement bases)**

<b>Historical cost + Modified historical cost</b>		
<b>Current synonyms</b>	<b>Definitions</b>	
	<b>Asset</b>	<b>Liability</b>
<b>Past (net) entry price (PEP)</b>  <b>Original acquisition /purchase price</b>  <b>Original entry value</b>	The net amount of cash or cash equivalents paid or the cash equivalent of other consideration given in exchange for an asset, ignoring any amounts paid for transaction-related goods or services.	The net amount of cash or cash equivalents paid or the cash equivalent of other consideration received in exchange for incurring a liability, before deducting any fees or amounts paid for transaction-related goods or services.
<b>Past gross entry price (PGEP);</b> <b>Original transaction /purchase price/cost</b>	PEP (+) amounts paid for transaction-related goods or services.	PEP (–) any fees or amounts paid for transaction-related goods or services.
<b>Accumulated past entry price</b>  <b>Accumulated cost</b>	The sum of all amounts of cash or cash equivalents paid or the cash equivalents amount of other considerations given to construct or assemble an asset over an extended period of time, including those amounts paid for transaction-related goods or services.	The amount of originally recorded PEP, PGEP, past exit price or past net exit price that remains after assigning some of that price to subsequent accounting periods according to an accounting rule for amortization or depreciation.
<b>Allocated cost / past (gross) entry price</b>	The amount arrived at by allocating a PEP or PGEP to multiple assets or liabilities.	

<b>Historical cost + Modified historical cost</b>		
<b>Current synonyms</b>	<b>Definitions</b>	
	<b>Asset</b>	<b>Liability</b>
<b>Amortized / depreciated past price</b> <b>Amortized cost</b>	The amount of originally recorded PEP or PGEP that remains after assigning some of that price to subsequent accounting periods according to an accounting rule for amortization or depreciation.	
<b>Combined past price</b>	The amount arrived at through the combination of two or more of the previous bases.	

Data source used for definitions: <<http://www.iasb.org/NR/rdonlyres/FIACC69B-9FE8-4156-A7E5-OBDD708848526/0/Attachment2TermsDefinitionsSynonymus.pdf>>

As results from tab. 2 an entity using the **historical cost model** for some asset (for example for property, plant and equipment) could be using as many as six different historical cost bases.<sup>5</sup>

In some practice, the historical cost of *an asset* is understood simply as the amount paid for it and historical cost of a *liability* as the amount received with respect to it or the amount expected to be paid to satisfy it. In the case of an asset the historical costs are usually interpreted as the amount at which an asset is stated in the accounts and which should not exceed the amount expected to be recovered from either its sale or its use. Therefore it is currently understood as *recoverable historical cost* rather than original entry value and is usually considered to be higher of the asset realisable value<sup>6</sup> and its value in use.

### 3.3 Rushed Classification

Measurement bases have been traditionally characterized in terms of *historical cost* versus *current value* (respectively – in latest time – as historical cost versus fair value) though historical cost and current value are rather two families of measurement bases. As we saw in table 2, the **historical cost family** includes the price/value as original entry value,

<sup>5</sup> An entity using for some asset historical cost model will probably use additional bases. For example in the case of inventory: current exit price (IAS 2, par. 31, expressed as net realisable value), current identical replacement *entry price* or *current identical reproduction entry price* (ARB 43, ch.4, par. 7).

<sup>6</sup> The asset fair value minus cost of sale pertinently.

original transaction price, amortized cost, accumulated cost, allocated cost, as well as their various combinations. In spite of this, historical costs are often understood as one base. On the contrary, the **current value family** is often presented as various measurement bases (Kovanicová), but some authors use several terms to describe what is really just one base (as Table 3 shows).

**Tab. 3: Current value family bases: illustration of usual synonyms**

Measurement bases	Frequent Synonyms
<b>(Current) replacement cost (only for assets)</b>	Current: <ul style="list-style-type: none"> <li>▪ identical / equivalent replacement entry price</li> <li>▪ replacement productive capacity entry price</li> </ul>
<b>Reproduction cost (only for assets)</b>	Current identical reproduction entry price
<b>Realisable value</b>	(Current) exit value; Net realisable value
<b>Current consideration amount (for liabilities)</b>	Current equivalent proceeds Replacement loan amount Current proceeds
<b>Value in use</b>	Discounted value of future cash flows Present value of future cash flows Present value
<b>Value to business</b>	Deprival value <sup>7</sup> (for asset) Relief value <sup>8</sup> (for liability)
<b>(Current) cash equivalent</b>	Assets: Current exit value Current market value Net realizable value Liabilities: Cost of release Settlement value
<b>Fair value</b>	Current exit price Current equilibrium price

<sup>7</sup> The value an entity would lose if it were deprived of an asset.

<sup>8</sup> The amount an entity would be better off if it were relieved of liability.

Imperfectly sophisticated classification and inconsistent terminology leads to worse understanding one to another. Taking the time to clearly define, describe and understand the various historical cost modifications and current value variants and to select one label for each variant improve the quality of the measurement phase deliberation and the completed conceptual framework.

Therefore, understanding the nature and attributes of those bases in first milestone of measurement project is precondition to evaluating two families of bases – historical cost and current cost/value – in the second milestone. Before it there will be useful to recall at least how some current bases (analysed later) work:

- a) *Realisable value*: The amount for which an asset could be sold, and a liability could be settled. Realisable value measurements are often made on a net basis, which is net of selling costs (for assets) and grossed up for settlement costs (for liabilities). Realisable value shows the value on net assets if sold separately (net of costs) and income based on that.
- b) *Value in use*: discounted value of the future cash flows attributable to an asset or liability. It shows the present value of future cash flows and an economist's measure income.
- c) *Value to the business*: it tries to answer the question: how much worse off would the business be if it were deprived of any given asset? The way of answering depends on purpose of the asset: it may be held for sale, held to be used or be replaced. This value depends on the relationship between the values calculated for net realisable value, value in use and replacement cost (Kovanicová, 2004c). Value to the business shows the costs of entry (or replacement) and income after maintaining capability.
- d) *Fair value*: it is neither an actual buying (input) nor an actual selling (exit) price, but a theoretical value. According to latest FASB regulation (SFAC 157) the fair value is defined as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement

date.” (IASB, 2006, p. 10).<sup>9</sup> Although certain vagueness in the concept of fair value makes it difficult to say exactly what it means (Kovanicová, 2004b), the definitions incline to an exit value. If an asset is sold separately, fair value shows the value of the net asset and the income based on that.

#### **4 Which Measurement Base/Bases?**

There is widely recognized that so-called “mixed measurement model” could produce results that do not reflect the underlying economics in some situations. You could ask: could some model using more than one base reflect economics of many types of business properly? Or: why not only one measurement base is used for all financial statement purposes? Which measurement base will be best of all for that particular purpose? Conceptual framework project has to answer many critical questions in future five years, when it will finish. The answers will not be easy and can be neither definite.

From this point of view, there is an interesting report of the Institute of Chartered Accountants in England & Wales (ICAEW, 2006), in which five bases of measurement are analysed: historical cost (unfortunately without their various modifications), value to the business, fair value, realisable value and value in use.

ICAEW report argues that in forming a judgment on the appropriateness of measurement bases, the overriding tests should be their cost-effectiveness and fitness to purpose. In the absence of direct evidence on these matters it argues in terms of relevance and reliability as the most important characteristics of faithful presentation in financial reporting (table 4).

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<sup>9</sup> IASB has adopted FASB Statement of Financial Accounting Standard No. 157 – (SFAS 157) as the second part of its Discussion Paper Fair Value Measurement.

**Tab. 4: Measurement bases applicability from the point of two qualitative characteristics (summary of key arguments)**

<b>Bases</b>	<b>Reliability</b>	<b>Relevance</b>
<b>Historical Cost</b>	Reliable when based on actual transactions. Subjective when based on predictions and allocations.	<i>For</i> : matches costs with realised income. For most companies, aligned to management information. <i>Against</i> : Based on out-of-date measurements. Ignores unrealised gains. Measures some key assets and liabilities as zero.
<b>Realisable value</b>	Reliable when based on active markets or actual realisations. Subjective where there are no reliable market values or actual realisations.	<i>For</i> : Shows sale values (net) and therefore the opportunity costs. Shows expected value of risk-adjusted future cash flows for some assets. <i>Against</i> : Shows measurements based on a rejected alternative. Can show asset values at sub-optimal level of aggregation.
<b>Value in use</b>	Subjective because based on predictions.	<i>For</i> : Shows present value of expected future cash flows and economist's measure of income. Relevant to standard-setters' stated objective. <i>Against</i> : Measures changes in expectations rather than actual performance. The market should be left to value the business.
<b>Value to the Business</b>	Reliable when there are markets for comparable replacement assets. Subjective when technologies and markets change, and when based on predictions and	<i>For</i> : Shows costs of entry to new entrants. Shows whether operating capability is being maintained. <i>Against</i> : Maintenance of operating capability, not the priority for investors. New entrants' perspective is not the most relevant for existing investors.

Bases	Reliability	Relevance
	allocations	
<b>Fair value</b>	Reliable when based on active markets. Subjective where there are no reliable market values.	<p><i>For:</i> Shows sale values (gross), therefore opportunity cost. Shows expected value of risk-adjusted future cash flows for some assets. Some financial analysts regard it as the only information relevant for financial decision-making.</p> <p><i>Against:</i> Shows measurement based on a rejected alternative. Can show asset values at sub-optimal level of aggregation.</p>

Data source: ICAEW 2006, p. 37

Though a broad generalization about measurement reliability is not desirable as this question is more sophisticated, to analyse and describe it could be useful for further research.

## Conclusions

1. In several latest years both international regulators – FASB as well as IASB – preferred fair value measurement base as the best measurement tool. They determine that fair value is more relevant than the other alternative measurement bases – especially for initial recognition. They argue that other bases directly or indirectly incorporate less objective entity-specific measurements. In the framework of their present standard setting process (IASB Discussion Paper 2005 and FASB Standard FAS No. 157, 2006) they step by step magnified the scope of fair value applications provided it could be measured reliably.
2. Tendency to one measurement base is being developed without serious research and could not solve great inconsistency in measurement. Moreover, perceived direction of change in financial reporting towards the greater use of fair value is a source of widespread unease.
3. FASB/IASB joint conceptual framework gives a great opportunity to change this situation. Their common decision to include measurement

as a key topic in this project drives towards greater theoretical consistency. Its main purpose is:

- to develop and integrate common accounting language by means of identifying, defining and describing the measurement bases;
  - to improve understanding of how different measurement bases work;
  - to identify key points in the arguments for and against each bases of measurement.
4. Joint measurement project is a coherent part of the long-term evolutionary process in financial accounting and reporting measurement. This evolution started at the beginning of the 21<sup>th</sup> century by gradual leaving of poor historical cost towards their modifications and later towards current value family bases.

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### **ABSTRACT**

Though measurement is a key aspect of financial accounting and reporting, fundamental measurement issues remained outside proper consideration for a long time and yet have not been solved satisfactorily. This situation is typical not only for many various national jurisdictions, but even for the US GAAP and IFRS. The measurement provisions in their Conceptual *Framework* and *Standards* are bounded, inconsistent and being treated unsatisfactorily. The combination of history and ad hoc regulation by a few generations of standard setters has resulted in the “mixed bag” of measurement bases used today.

On the background of two latest measurement research projects (IASB Discussion Paper *Measurement Bases for Financial Accounting – Measurement for Initial Recognition* and joint FASB/IASB *Conceptual Framework Project – Measurement Phase*), the article poses a set of questions that should be solved at several next years and discusses the main issues in financial reporting measurement, especially the terminology dissonance and rushed classification leading to widespread professional miscommunication.

**Key words:** Measurement Bases; Conceptual Framework; Measurement Research Projects; Issues in Measurement.

**JEL classification:** M41.