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Investor Perspectives

# Taking a measured approach

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A member of the IASB explains the proposals on measurement in the *Conceptual Framework* project

In my eight years at the IASB, I have found that there is little more likely to provoke a heated debate between standard-setters—and also among our stakeholders—than the question of how best to measure a particular asset or liability. This is understandable, because decisions about measurement are fundamental to the portrayal of financial position, and, importantly, to the reporting of financial performance.

But have all these spirited discussions been as productive as they might have been? Some of the debates over the years would probably have been more focussed if the IASB had provided more guidance about measurement in its 'handbook' for standard-setting—the *Conceptual Framework*. You may be surprised to learn that the IASB's *Conceptual Framework* currently has little to say on this fundamental topic.

### Figure 1. What is the *Conceptual Framework*?

The *Conceptual Framework for Financial Reporting* describes the objective of and concepts for general purpose financial reporting; it deals with issues such as the definitions and measurement of assets and liabilities and when and how income and expenses should be recognised and presented.

The purpose of the *Conceptual Framework* is to help the IASB set Standards. It also helps others understand and interpret IFRS. It is not a Standard and does not override the requirements of individual Standards.

The IASB aims to correct this. In its 2015 Exposure Draft of proposed changes to the *Conceptual Framework*, the IASB proposes a more extensive measurement section that:

- describes the different measurement methods that might be used (see Figure 2), and
- discusses the factors that the IASB should consider when selecting an appropriate measurement method to apply in any given situation.

As with all things to do with measurement, we expect our proposals for this new section of the *Conceptual Framework* to stimulate a lively discussion within the accounting community and to result in many suggestions for improvement.

I have written this Investor Perspective in the hope that it will encourage investors to participate in this debate. In it, I set out my thoughts on five key questions related to selecting a measurement method that I consider most relevant for investors.

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## Figure 2. Measurement methods

There are many different ways in which an asset or liability can be measured. Some rely partly or wholly on information derived from a past transaction (historical cost). Others reflect current circumstances and make no use of historical information (current value). Neither approach is without its practical and conceptual challenges.

- **Historical cost**

  It may seem easy to determine the historical cost of an asset or liability, and in simple situations it is easy to determine initial cost—the cash paid or received. But introduce, for example, a deferred payment, for which the time value of money needs to be considered, or a payment with consideration other than cash, and things become more tricky. In addition, determining historical cost after initial recognition is not straightforward. Historical cost relies on rules and conventions to specify what is included and how it should subsequently be adjusted (for example, rules and conventions about depreciation and impairment). The need for these rules and conventions causes complexity and makes it challenging for investors to interpret the output.

- **Current values**

  Current values come with a variety of alternative valuation methodologies. One could use (or estimate) prices quoted in a market (fair value) or alternatively one could use (or estimate) entity-specific factors to arrive at a current value (value in use for assets and fulfilment value for liabilities). In addition, current values could be 'customised' by, for example, using a combination of market and entity-specific estimates.

  Of these alternative methods, only current market prices can be described unambiguously (although even for fair value there are questions, for example about which market price is most relevant). Any other current value is likely to require specific rules or conventions to make it operational and to avoid inconsistent application. This drawback is something that these other current values share with historical cost.

Fortunately for those drafting the revisions to the *Conceptual Framework*, details on how these measurement methodologies might be applied in practice are considered within each individual accounting Standard, and not in the *Conceptual Framework* itself.

## Selecting a measurement method

A controversial aspect of measurement—and the issue I expect will receive most attention in the comments we receive—is: when should each of these measurement methods be used? From an investor's perspective, I think it is also worth highlighting five key questions that are dealt with by the draft *Conceptual Framework*.

1. Should a single measurement method be applied to all recognised assets and liabilities?
2. In selecting a measurement method, should one consider the impact on, and relevance for understanding, financial position, financial performance, or both?
3. How should the ease or difficulty of establishing a given measure affect the choice of measurement method?
4. Should the way in which the asset or liability is used within a business affect the choice of measurement method?
5. Would using one measurement method for determining profit or loss, and a different one in reporting financial position, enhance the usefulness of financial statements?

I consider each of these questions in the remainder of this article.

## 1. A single measurement method?

Some of our constituents, including some investors, argue in favour of a single measurement basis for all recognised assets and liabilities. They contend that when aggregating assets and liabilities, the resulting totals and subtotals can have little meaning if different measurement methods are used. Similarly, profit or loss may lack relevance if it reflects a combination of flows based on historical cost and of value changes for items measured on a current value basis. Those that advocate a single measurement method tend to favour the use of current values (for example, fair value), arguing that such updated measures provide the most relevant information.

However, the vast majority of those who comment on the work of the IASB (including, in my experience, the majority of investors) favour a mixed measurement approach, by which the most relevant measurement method is selected for each category of assets and liabilities. Investors often tell us that this approach is consistent with how they analyse financial statements. In spite of net income and shareholders' equity getting a lot of attention in the Press, equity analysis is generally at a much more detailed level. For this reason, investors tell us that the problems of mixed measurement at an aggregate level are outweighed by the greater relevance achieved if the most relevant measurement basis is used for each class of assets and liabilities.

The view that a mixed measurement approach can provide more relevant information is reflected in recent standard-setting decisions made by the IASB. For example, the IASB has recently issued IFRS 9 *Financial Instruments* and IFRS 15 *Revenue from Contracts with Customers*, and will shortly issue a Standard on insurance contracts (final deliberations on the new Standard are in progress). In each case, during the initial research phase we considered the consistent use of the same measurement method for all of these Standards. Historical cost would not be relevant for all financial assets and has severe limitations for many liabilities, particularly insurance liabilities; hence, the only viable single measurement method would have been fair value. Because of the interactions between these three Standards, a single fair value model would have undoubtedly made for simpler Standards.

However, in spite of the attractions of a single measurement basis, the IASB has decided not to pursue such an approach for these three Standards. There were several reasons for this, not the least being that the IASB considered that fair value would not provide the most relevant information in all circumstances. IFRS 9 requires the use of cost in some cases and fair value in other cases, while IFRS 15 essentially applies cost allocation. A version of current fulfilment value is proposed for insurance contracts, albeit with aspects of cost thrown in.

Considering our past standard-setting activity, it should therefore be of no surprise to see that the draft *Conceptual Framework* does not propose a single measurement method for all assets and liabilities, and instead supports the continued use of a mixed measurement approach.

## 2. Relevance for financial position or financial performance?

'The IASB only cares about the balance sheet.' We hear this mistaken claim time and time again. The perception that financial position is more important to the IASB, and that it drives the selection of measurement method, is false. Performance measures are clearly critical for investors and this is recognised in accounting Standards development. The key question is not whether performance is relevant when selecting a measurement method; that is not in dispute. Instead, the challenge is to determine what type of performance is most relevant in any given situation.

*In selecting a measurement method, should one consider the impact on financial position, financial performance or both?*

For example, the performance of an investment company could be represented by the change in value of the investment portfolio, which would require current value measurement. Alternatively that performance could be represented by the 'realised gains' on those investments sold in the period, which would result from a historical cost measurement. In each case there could be variations or enhancements that might influence the measurement method selected. A current value system could be augmented by an analysis of the value change into different components, such as separating the interest, dividends or other periodic flows that the investments generate from the residual value changes. A cost system would include application of an impairment approach in cases in which the value of investments falls even though the loss is unrealised—ie measurement using so-called recoverable historical cost. A further approach might even be to combine both cost and fair value measures into a single more complicated picture of performance. It is this approach that the IASB took in IFRS 9 for some debt instrument assets. Here, a recoverable cost approach is used for measuring profit and loss and a fair value approach is used to measure comprehensive income and to determine balance sheet values.

This is not to say that financial position in isolation is unimportant; far from it. In the case of an investment company, it would seem unlikely that investors' needs would be fully met if current values were not reported in its statement of financial position, considering that the prime interest of investors is likely to be the value of that investment portfolio. But what this example clearly illustrates is that selecting a measurement basis requires a holistic consideration of investors' information needs and how these can best be satisfied. This means considering the reporting in all the financial statements, including how this information can best be presented and disaggregated, and how additional disclosures can be most effectively used. The draft *Conceptual Framework* reinforces this approach. It emphasises that when the IASB selects the measurement basis to use in a particular case, it should consider the nature and relevance of the information that such a measurement will provide about both financial performance and financial position.

## 3. What is the impact of measurement uncertainty?

Most accounting measures of assets and liabilities are uncertain and require estimation. While some measures of historical cost are straightforward (it is the amount paid or received), there are many occasions when the measurement of cost can be uncertain—particularly recoverable cost, for which impairment and depreciation estimates are required. In a similar vein, while some measures of fair value can be easily observed because of the availability of prices in an actively traded market (a so-called 'Level 1' fair value), others inevitably rely on management estimates and judgements ('Level 2' and 'Level 3').

*How should the ease or difficulty of establishing a given measure affect the choice of measurement method?*

The IASB considers measurement uncertainty when selecting a measurement basis. If, for example, there are two alternative measures of an asset or liability and each is judged to have equal relevance to an investor, then selecting the method with less measurement uncertainty would seem sensible. Of course, in practice such a simple choice is highly unlikely to be available. Instead, when considering alternative measures, we are typically faced with a number of different factors that influence our final decision.

Take for example an unlisted equity investment. Such investments are required to be measured at fair value. Because the investment is not traded, management judgement will be needed to estimate its fair value. This leads to measurement uncertainty. While the added measurement uncertainty might arguably reduce the relevance of the resulting value, in the view of the IASB this is more than offset by the increased relevance of a fair value compared to alternative measures that do not capture changes in the investment's value, such as historical cost.

In some circumstances, measurement uncertainty is considered to be so large (and the consequential reduction in relevance so great) that the IASB will not use a particular measurement approach. To take an extreme example, if no alternative measure can be found that provides relevant information, then it may be that investors are best served if an entity does not recognise the asset or liability at all. Consider product research activities undertaken by an entity. Much of this activity adds value and creates intangible assets that would meet the accounting definition of an asset. However, current accounting Standards require that most such expenditure is immediately recognised as an expense and no asset is recognised. Why? Measuring such an asset at current value is highly challenging. Although historical cost measurement is arguably easier, there would still be significant difficulties in establishing what expenditure should be part of that cost and in determining subsequent amortisation and impairment. Cost would also be much less relevant as a measurement, because of the often tenuous link between the amount invested in research and the subsequent benefits derived from it. All of these considerations have led the IASB to decide that such an asset should not be recognised in the first place.

*Measurement uncertainty is not the same thing as volatility.*

Perhaps one of the more contentious areas of this debate concerns volatility. I believe that it is important to differentiate between measurement uncertainty and volatility. The former applies at a point in time and reflects the difficulty of establishing a measure, while the latter applies over time and reflects the extent of a change in the measurement due to changed circumstances. For example, an investment traded in an active market may have a fair value that has little or no measurement uncertainty, but that value could nevertheless be highly volatile.

If a price is volatile, should it be used to measure an asset or liability? Some use price volatility as an argument against 'mark to market' or fair value. I disagree. High measurement uncertainty might reduce the quality of information available to investors. However, in my view, high price volatility is not a financial reporting problem, even though it may make analysing an investment in that entity more challenging. If a *relevant* measure of an asset or liability value is volatile, this should not be hidden from investors. To conceal its volatility would decrease the usefulness of the financial statements. Of course, such volatile gains and losses do need to be clearly presented and disclosed, because their predictive value may differ from that provided by other components of performance.

Measurement uncertainty features prominently in the proposed *Conceptual Framework*, where it is discussed in the chapters on the qualitative characteristics of financial information, recognition and measurement. Most seem to agree that measurement uncertainty is important, although views on how much weight should be given to it vary significantly. This is one factor that contributes to the very different views among our constituents on the extent to which current values (and more specifically fair values) should be used in financial reporting.

## 4. How should business activities affect measurement?

Another area of debate is whether an entity's business activities should affect the measurement of its assets and liabilities, and to what extent. Should the use to which an asset is put, and how it contributes to the wealth creation of a business (what one might call the entity's 'business model') affect the measurement of that asset? Can two identical assets that contribute to wealth creation differently be reported at different values in financial statements, with a different impact on performance measures? Some argue that such an outcome is undesirable and they attach a premium to consistent measurement. They would say that identifying the use of an asset is itself difficult and may be subject to change. It also introduces an element of management choice into financial reporting and adds complexity for investors. However, many of our constituents disagree with this view and would advocate applying different measurement methods, depending both on the nature of assets and liabilities and also, importantly, on how these are used in the business.

A good example of this is the reporting of real estate. Real estate could be measured at recoverable historical cost or at fair value. One could apply one measurement method to all properties or apply different measures depending on the business activity (for example, operating or investing) in which the asset is used.

In an operating business, the asset is used in combination with other assets and liabilities and resources such as human capital to generate profits by selling goods and services. Many argue that the most appropriate reporting of performance of such a business is to focus on the flows rather than current values. This would include the flow represented by the consumption of the property (as reflected in the depreciation charge) and hence recoverable cost measurement is most appropriate. Because a sale is not the primary means of extracting value from the asset, reporting performance based on current values may be less relevant.

Contrast this with an investment business activity, in which the asset is held for its potential to generate an investment return through being held for rental income or through its sale. Many would argue that cost-based measurement in this situation is less relevant than fair value and that the change in the value of the properties is an important part of the business's financial performance.

Alternatively, in my example above, all properties, including those in an operating business, could be reported at current value. This does not necessarily make the flow-based operating result less useful. It may actually improve it, because depreciation is more up to date. In addition, investors also get to see the change in value of the assets, which is arguably still important because of the option to change how assets are deployed, even if immediate sale is unlikely.

However, measuring all properties at their current values may make it more costly to prepare financial statements and arguably increases the degree of measurement uncertainty. It could also reduce the relevance of a flow-based operating result, because this is now more hypothetical than if it were based on the actual price paid.

Real estate activities are only one example of where one might consider how an asset or liability is used in a business when deciding on a measurement method. There are many such situations and each has its own particular considerations. What is clear is that the IASB has in the past taken this factor into account when selecting a measurement method. The proposal in the *Conceptual Framework* Exposure Draft is that we should continue to do so. The difficulty is exactly how. What criteria or guidance should be provided regarding how business activities should be taken into account?

The guidance in the draft *Conceptual Framework* is deliberately high level. It says ... *'To produce relevant information, it is important to consider when selecting a measurement basis for an asset or a liability and the related income and expenses how that asset or liability contributes to future cash flows. This will depend in part of the nature of the business activities conducted by the entity….'*.

Can this be made more specific? Can our proposed guidance for selecting a measurement method be improved?

## 5. Could measurement for performance differ from that used for financial position?

As I have said, when selecting a measurement method the IASB takes into account the impact on both the statement of financial position and on performance metrics. On occasion, the IASB has decided that this aim is best met by selecting more than one method of measurement, ie by using one measurement method for financial position and a different method for at least one aspect of performance. By doing this, part of the overall value change represented in the balance sheet is presented outside profit or loss, in other comprehensive income (OCI).

One example of this is the requirement in IFRS 9 to measure some financial assets at fair value through OCI (FVOCI). The IASB considers that both fair value and amortised cost measurement methods produce relevant information for assets that fall into this category. Information about the asset's fair value is provided in the balance sheet, with the primary measure of performance (profit or loss) presented on a cost basis.

Not everyone agrees with this approach (sometimes called a 'dual measurement'). Some would argue that it adds complexity to financial reporting and that if a particular measure is regarded as being the most relevant then it would be best to use it consistently across the financial statements (albeit with disaggregation of performance metrics where appropriate). Indeed, I personally disagreed with the application of dual measurement in the FVOCI category of IFRS 9, although I can see that there may be other circumstances in which such an approach could result in the most relevant and understandable depiction of performance.

In the Exposure Draft for the revised *Conceptual Framework*, the IASB proposes to permit the use of this dual measurement approach. The difficulty is identifying when such a use is appropriate. The draft at present essentially says this should be where the result enhances the relevance of profit or loss as the primary measure of performance for the period. But can we be more specific about when dual measurement helps investors and when it might merely confuse?

### Investor input is encouraged

I have not considered all aspects of measurement in this article, but I hope it is sufficient to highlight some of the challenges faced by the IASB in both deciding on a framework for measurement and in selecting particular measurement bases in individual Standards. Your thoughts on this article and on the other parts of the *Conceptual Framework* Exposure Draft would be very welcome.

Please feel free to reply to me directly with comments on the article or write a comment letter on any aspects of the Exposure Draft.

## Get in touch

To submit a comment letter, please visit: **go.ifrs.org/comment_CF**

If you would like to discuss this topic or other areas of accounting, please contact:

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