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International
Accounting Standards
Board

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These notes are based on the staff papers prepared for the IASB and FASB. Paragraph numbers correspond to paragraph numbers used in the joint IASB-FASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IASB Meeting: November 2008, London

Project: Conceptual Framework: Measurement (Phase C)

Subject: Factors to Consider in Selecting a Basis for Measurement after Initial Recognition (Agenda paper 3)

PURPOSE OF THIS MEMO

1. The purpose of this memorandum is to suggest a way forward for the measurement phase of the conceptual framework. It discusses five factors that might be considered in determining the most appropriate way to measure assets and liabilities that are recognized in the statement of financial position.
2. Most of this memorandum discusses measurement after the date of recognition. A short section at the end discusses measurement at initial recognition for items for which there are no transaction prices.
3. This memorandum uses the term *measurement* to refer not only to those quantifications that qualify as measurements in a strict sense, but also to estimates of such measurements and to formulaic numbers used in financial statements that may not qualify as measurements in a strict sense.

4. Because the draft framework chapter on objectives states that users need similar information to assess cash flow prospects and stewardship, only the assessment of prospective cash flows will be mentioned in the remainder of the memorandum.

MEASUREMENT AFTER INITIAL RECOGNITION

5. The objective of financial reporting entails providing decision-useful information to present and potential investors and creditors who are trying to assess prospects for future cash flows. Items recognized in financial statements should be measured in ways that facilitate those assessments.

The Theoretical Ideal

6. Given the objective of financial reporting, the theoretically ideal way to measure an asset or liability would be to determine the actual outcome of having or using that item (that is, the amount and timing of future cash flows or other economic value flows) and discount that outcome at the time value of money. Unfortunately, no outcome is ever 100 percent certain until it actually occurs. There is always some possibility that the amount or timing of actual cash flows will vary from what they are forecast to be.
7. Thus, the theoretically ideal measurement method could only be used by waiting to recognize an asset or liability until after the ultimate cash flow outcome of that item has occurred. That would be feasible only if the outcome were to occur shortly after the reporting date. For many items, the ultimate outcome will not be known until after a financial report has been issued, years later in many cases. Waiting for a future outcome to occur would also be counter to the idea that financial statements should reflect facts and conditions known to exist at the reporting date.

Real Choices

8. Because the ideal is unattainable, the Boards will need to determine the best measurement available in real situations.
9. The Boards have discussed several measurement bases that might be used for remeasurement. Those bases may be grouped into three main categories, as follows:
 - a. Current-value based (including market prices and price estimates)

- b. Past-value based (including transaction prices, original costs, and original proceeds, with possible adjustments such as depreciation, interests accruals, and valuation adjustments or allowances)
- c. Anticipated-value based (including asset measures based on anticipated selling prices and liability measures based on anticipated settlement outcomes).

Under Optimal Measurement Conditions

- 10. Under optimal conditions for measurement that can exist in real situations, a current-value measurement clearly would be better for assessing prospects for future cash flows than a measurement based on past or anticipated values.
- 11. The optimal conditions for using a current value measurement include:
 - a. The current value can be observed at little or no cost
 - b. The item to be measured is readily convertible to cash, that is, it is either:
 - i. An asset that represents a right to receive cash or that is readily marketable for a known amount of cash, or
 - ii. A liability that represents an obligation to pay cash or that could readily be laid off for a known amount of cash
 - c. Changes in the current value of an asset or liability can be separated from related cash flows and contractual accruals, thus facilitating user assessment of prospective cash flows
 - d. Current values are available for all assets or liabilities that generate cash flows as a group.

Under Suboptimal Measurement Conditions

- 12. Optimal measurement conditions do not exist for most assets and liabilities of most reporting entities. Therefore, in identifying a measurement basis to be used in a particular standard, the Boards usually will need to consider all three categories of measurement bases mentioned in paragraph 9.

13. Thus, the Boards' standards-level decisions about measurement of specific items in the statement of financial position would need to consider the following factors whenever optimal conditions for using current values do not exist:
- a. *Value/flow weighting and separation.* The relative importance to users of information about the current value of the asset or liability versus information about the cash flows generated by the item, as well as the ease and precision with which the flows can be separated from the value changes (an indication of relevance)
 - b. *Confidence level.* The level of confidence that can be placed on alternative measurements as representations of the asset or liability being measured (an indication of faithful representation)
 - c. *The measurement of similar items.* Items of a similar nature should be measured in similar ways (an indication of comparability)
 - d. *The measurement of items that generate cash flows together.* Items that generate cash flows as a unit should be measured the same way (an indication of understandability)
 - e. *Cost-benefit.* An assessment of the ratio of the benefits that would be derived from alternative measurements to the costs of preparing those measurements (an indication of the primary limiting factor in financial reporting).

Under the optimal conditions listed in paragraph 11, all five factors would support the use of a current value. With anything less than those conditions, the five factors would need to be evaluated for each measurement basis considered.

Value/flow Weighting and Separation

14. Some assets must be used to produce a good or service that will result in net cash inflows. When assessing cash flow prospects for those assets, their current value is generally less important than the cash flows they generate. Such assets are "flow-dominant" assets because the flows that will result are a multiple of the asset value. An investor assessing cash flow prospects normally would put more weight on those assets' flows than on their value. If those assets were regularly remeasured at a current value, the cash flows and value changes attributable to them would need to be separated in the statement of comprehensive income.

15. In addition, unique capabilities of an entity and its management and employees generally are not represented in the entity's financial statements and would be very difficult to faithfully represent. Some would be internally generated intangible assets, but others might be synergies or other qualities that would never qualify as assets. Those factors may have such a significant influence on the cash flow generating ability of the entity that they overwhelm the effects on future cash flows of changes in value of the recognized assets. (That analysis would not generally apply to the value-dominant items discussed in paragraphs 16 and 17.)
16. Other assets will produce cash flows by being collected or sold. Such assets are "value-dominant" assets because the flows produced are directly related to the value of those assets in market exchanges. Similarly, most liabilities are value dominant because their values are directly related to the cash flows required to extinguish them. For value-dominant assets and most liabilities, an investor assessing cash flows prospects would normally put more weight on those items' values than on their currently reported cash flows.
17. Finally, for some assets, such as loan assets and leased assets, both the value and the flows (interest revenue and rent revenue) are important and the weighting of values and flows may vary.
18. Using a current value measurement would be more important for a value-dominant item than for a flow-dominant item. Confidence level and cost-benefit considerations would weigh heavily in determining the appropriate measurement for flow dominant items. The ability to separate value changes from flows in comprehensive income would also be a factor.

Confidence Level

19. The use of the term *confidence level* here is roughly analogous to its use in statistics, which applies to statistical estimates. A high confidence level means that a measurement is highly likely to be within a range that would be considered a faithful representation of the value that the measurement is intended to represent.
20. Because many non-measurement quantifications (such as transaction price less accumulated depreciation) are formulaic and are not necessarily intended to represent a value, or any economic phenomenon, confidence level really does not apply. The only

question in those cases is computational accuracy, which is subject to relatively easy verification. Nevertheless, that ease of verification may be considered equivalent to a high level of confidence for purposes of this analysis.

21. Other non-measurement quantifications are intended to represent economic phenomena. For example, reporting a loan receivable at the transaction price plus accrued interest adjusted for an estimate of incurred losses is intended to represent anticipated future cash flows. In those cases, the term confidence level applies.
22. Measures that can be obtained directly from active markets would be assigned high confidence levels. As more adjustments to market observations are required, the confidence level would decline.
23. Estimates of incurred losses are not formulaic and usually are not observable. Quantifications of that type would generally be assigned less than the maximum levels of confidence, but the level would vary depending on the circumstances. An example of such quantification would be a valuation allowance for loan losses.

The Measurement of Similar Items

24. Reporting assets and liabilities of a similar nature using the same measurement basis improves comparability and thus assessment of prospective cash flows, both within a single reporting entity and among reporting entities.

The Measurement of Items that Generate Cash Flows Together

25. The report of the SEC Advisory Committee on Improvements to Financial Reporting included a recommendation that items used in the same activity should be measured in the same way. It could create confusion for users if entities reported some productive assets at original transaction price adjusted for depreciation and reported others used in the same process at current replacement cost simply because market prices are available for some but not others.
26. To avoid such confusion, decisions about measurement or quantification should be made for groups of assets rather than one by one.

Cost-benefit

27. The specific question asked by the cost-benefit factor is whether the cost to issuers of preparing a useful measurement or separating value changes from flows is justified by the benefit to users.
28. In general, costs to prepare formulaic quantifications based on transaction prices are minimal and the result is easily verifiable. An example is transaction price less accumulated depreciation.
29. Costs to prepare estimates of incurred losses would likely be higher (and the result is not as easily verifiable, which leads to a lower confidence).
30. Costs to prepare estimates of current value vary significantly depending on the availability of relevant current information.

MEASUREMENT AT INITIAL RECOGNITION

31. The mechanics of double entry bookkeeping result in most items being recognized at the transaction price (the value of the consideration given or received in exchange for the newly recognized item). There are three notable exceptions:
 - a. Assets acquired and liabilities incurred in business combinations or other bundles
 - b. Internally constructed or internally developed assets
 - c. Assets and liabilities for which there are no transaction prices.

Business Combinations and Other Bundles

32. There are no individual transaction prices for assets and liabilities acquired and assumed in a business combination. Those items are individually reported at amounts prescribed by standards—many at fair value and some at other amounts.

Internally Constructed or Developed Assets

33. Some assets are constructed or otherwise developed by the entity and in those cases the initial measurement is a result of accumulation of the costs incurred. The determination of which costs are to be accumulated is presumed in this memorandum to be a standards-level

issue rather than a conceptual issue since it varies according to the specific type of asset (for example, physical assets and R&D assets).

Assets and Liabilities for Which There Are No Transaction Prices

34. There are some assets for which there is no transaction price, in the sense of a cash price, such as contributed assets and assets received in exchange for other assets. A current value for a contributed asset or for either asset in an exchange may be used to measure the asset received in those situations.
35. Some liabilities do not result from transactions and therefore there is no transaction price, for example, liabilities imposed by courts in lawsuits or out of court agreements to pay damages. Determining when to recognize such liabilities should be addressed in the recognition and measurement chapter, but the measurement chapter should address the amount at which those liabilities would be reported at the recognition date.
36. Possible ways to measure or otherwise quantify liabilities without transaction prices include:
 - a. The best estimate of the most likely outcome
 - b. A probability weighted estimate of the possible outcomes
 - c. A minimum value (best case outcome)
 - d. A maximum value (worst case outcome)
 - e. Midpoint of the range of possible outcomes.
37. Results from any of those methods could be discounted or undiscounted. If discounted, the discount rate could be market driven, entity specific, or otherwise predetermined by the Board.
38. Eventually the Boards should identify a single method or at least reduce the number of possibilities.

NEXT STEPS

39. During November Board meetings, the staff will ask Board members whether they agree with the approach to measurement outlined in this memorandum. If there is sufficient

support for that approach, the staff will ask Board members for direction for discussing and developing supporting detail.