STAFF PAPER

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IASB Meeting

Project	**Conceptual Framework**
Paper topic	Measurement - Initial measurement

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Purpose of paper

1. The purpose of this paper is to discuss what the *Conceptual Framework* should say about initial measurement. This paper does not discuss transaction costs. We plan to bring a paper on transaction costs to a future meeting.

2. This paper proposes a number of minor changes to the discussion of initial measurement that was included in the Discussion Paper. In particular, the staff propose to clarify that although, in general, the measurement basis used subsequently should be the same as, or at least consistent with the measurement basis used initially, this should not prevent:

   (a) current values being used in some circumstances as a deemed cost on initial measurement;

   (b) a change in measurement bases if such a change increases the relevance of the information provided.

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Background

3. The Discussion Paper:

   (a) stated that in order to make financial statements more understandable, initial measurement should be the same as, or at least consistent with, subsequent measurement.

   (b) stated that assets and liabilities are initially measured using one of the following three measurement bases:

      (i) cost-based measurements;

      (ii) current market prices (including fair value);

      (iii) other cash-flow-based measurements.

   (c) discussed the use of deemed cost in existing Standards.

   (d) stated that assets and liabilities may be recognised initially as a result of:

      (i) **Exchanges of items with equal value** - the Discussion Paper suggested that initial measurement issues are rarely significant for exchanges of this type and stated that the initial measurement of an asset or liability that arises out of an exchange of items with equal value could be described as cost or fair value because the two are normally the same. It went on to identify situations when this might not be the case.

      (ii) **Exchanges of items with different values** - the Discussion Paper discussed the problems associated with accounting for transactions of this type and suggested that accounting for assets or liabilities arising from such transactions at fair value would provide more useful information than accounting for them at the fair value of the consideration given or received.

      (iii) **Non-exchange transactions** - the Discussion Paper suggested that measuring at zero assets or liabilities that arise out of non-exchange transactions is indistinguishable from non-recognition and may not provide relevant information.

(iv) **Internal construction** – the Discussion Paper suggested that internally constructed assets should be measured at completion on the same basis as would be used for subsequent measurement. However, it noted that an alternative view would be that a completed asset is different from an asset under construction. Hence, using a different measurement basis on completion of the asset might provide relevant information.

4. The appendix to this paper includes the initial measurement paragraphs of the Discussion Paper.

Feedback

5. The Discussion Paper did not include a specific question on initial measurement. Consequently, few respondents commented on this section.

6. A few respondents disagreed with the suggestion in the Discussion Paper that, in order to make financial statements more understandable, initial measurement should be the same as or at least consistent with subsequent measurement. They stated that:

   (a) initial measurement at fair value should not preclude subsequent measurement at cost (ie fair value can be used as a deemed cost);

   (b) the measurement basis used initially may need to be changed if there is a change in the way that the item is used by the entity.

7. In addition, a few respondents:

   (a) Disagreed with the suggestion that initial measurement issues are rarely significant for exchanges of equal value. They stated that:

      (i) Perceptions of value are subjective so it is difficult to identify when an exchange is of equal value;

      (ii) Most transactions take place because the value of what is exchanged differs; both parties attach a greater value to what they receive than to what they give.

(b) Stated that fair value and cost are usually different because of transaction costs. Hence, it is incorrect to state that at initial recognition cost and fair value are the same.

(c) Stated that the discussion about whether the initial and subsequent measurement of internally constructed asset should be the same was inconclusive.

8. A few respondents to the Discussion Paper suggested that the discussion of initial measurement was too prescriptive for the *Conceptual Framework*. However, others suggested it should be expanded to include, for example, a discussion of the academic literature dealing with initial measurement or how to account for changes in estimates of the initial cost of items.

9. Finally, a few respondents requested additional guidance on how to determine cost including:

(a) whether interest should be included in the cost of an asset or liability;

(b) whether the carrying amount of items measured at cost should be adjusted to reflect changes in the amount of consideration payable (ie contingent or variable consideration);

(c) how to determine cost for assets or liabilities that arise on the settlement of forwards or options.

The staff believe that guidance of this type is beyond the scope of the *Conceptual Framework* (it is Standards-level detail). We, therefore, do not propose to include any additional guidance on these areas in the *Conceptual Framework.*

Proposed changes

10. The staff are proposing a number of changes to the discussion of initial measurement. The main changes are as follows:

(a) **Changes to the measurement bases** - in line with changes made elsewhere in the measurement section, we plan to replace references to the three measurement bases described in the Discussion Paper with references to historical cost and current value.

(b) **Removal of Standards-level detail** – this section of the Discussion Paper included some Standards-level detail that, in line with our agreed strategy for the measurement section, we propose to remove. For example, we plan to remove much of the discussion of deemed cost in paragraph 6.59.

(c) **Exchanges of items with equal value** – we plan to:

(i) remove the statement that initial measurement issues are rarely significant for exchanges of equal value. We continue to believe that this is true in most cases. However, it is probably unnecessary to state this in the *Conceptual Framework*.

(ii) clarify that cost and fair value are only the same if transaction costs are excluded from cost or are negligible.

11. We agree with those respondents who stated that the discussion of the measurement of internally constructed assets is inconclusive. However, we believe the discussion of the advantages and disadvantages of changing measurement basis on completion of an internally constructed asset is likely to be useful to you when developing Standards. Therefore, we propose to retain this discussion.

12. In addition, the staff propose to make some changes to the suggestion in this Discussion Paper that initial and subsequent measurement should be the same (or at least consistent). These changes are discussed in the following section (paragraphs 13 - 15).

Changes to the suggestion that initial and subsequent measurement should be the same

13. The IASB discussed at the July meeting the suggestion that, in order to make that financial statements more understandable, initial measurement should be the same as or at least consistent with initial measurement. You tentatively agreed to carry forward this suggestion to the Exposure Draft.

14. However, the staff believe that the concerns raised in paragraph 6 are valid.

(a) Current values are often used as a deemed cost on initial measurement (for example, when cost cannot be readily determined). This was discussed in paragraph 6.59 of the Discussion Paper but appears to have been overlooked by some respondents; and

(b) Changes in measurement bases are justified if they improve the relevance of the information provided (for example, when an entity reclassifies as an investment property a property previously held for use).

15. Consequently, the staff propose to clarify that although, in general, the measurement basis used subsequently should be the same as, or at least consistent with the measurement basis used initially, this should not prevent:

(a) current values being used in some circumstances as a deemed cost on initial measurement;

(b) a change in measurement bases if such a change increases the relevance of the information provided.

Question for the IASB

Question 1
Do you agree with the proposed changes to the discussion of initial measurement described in paragraphs 10 and 15?

Appendix – Initial Measurement paragraphs of the Discussion Paper

A1. This appendix includes the initial measurement paragraphs of the *Conceptual Framework* Discussion Paper.

Initial measurement

6.58 Assets and liabilities are measured initially using one of the following three measurements identified in paragraph 6.37:

(a) cost-based measurements;

(b) current market prices (including fair value); or

(c) other cash-flow-based measurements.

6.59 IFRS sometimes requires measurements that are based on a deemed cost. IFRS 1 *First-time Adoption of International Financial Reporting Standards* defines deemed cost as an amount used as a surrogate for cost or depreciated cost at a given date. Deemed cost might be used if:

(a) no consideration is given or if the fair value of the consideration given differs from the fair value of the asset acquired.

(b) an entity issues its own equity instruments to acquire an asset that will not be subsequently measured at fair value.

(c) an asset is transferred into a category that requires a cost-based measurement from a category that requires another measurement, for example:

(i) if a financial asset is reclassified in accordance with IFRS 9 *Financial Instruments* because of a change in the business model (the fair value on the date of the reclassification is deemed to be the instrument's amortised cost); or

(ii) if agricultural produce is harvested (prior to harvest, IAS 41 *Agriculture* requires measurement at fair value less costs to sell; at harvest, that amount is deemed to be cost for the purpose of applying IAS 2).

(d) determining cost is unduly onerous or impracticable, for example, in some situations when IFRS 1 permits an entity to use another amount as deemed cost.

(e) hedge accounting is used and the carrying amount of an asset has been adjusted for changes in value due to the hedged risk.

6.60 Assets and liabilities may be recognised initially as a result of:

(a) exchanges of items with equal value (see paragraphs 6.61–6.64);

(b) exchanges of items with different values (see paragraphs 6.65–6.67);

(c) non-exchange transactions (see paragraphs 6.68–6.70); or

(d) internal construction (see paragraphs 6.71–6.72).

Exchanges of items with equal value

6.61 For assets recognised as a result of exchanges of items with equal value, initial measurement issues are rarely significant.

6.62 In an exchange transaction:

(a) an asset is acquired in exchange for cash or another asset, or for an obligation to pay cash or another asset;

(b) services are acquired in exchange for cash or another asset, or for an obligation to pay cash or another asset; or

(c) a liability or equity instrument is issued in exchange for cash or another asset, or for a right to receive cash or another asset.

6.63 If an exchange transaction is negotiated by unrelated parties and neither party is in financial distress or otherwise under duress, the consideration given and received can normally be considered to be of equal value. In those cases, the initial measure of an asset or a liability could be described as cost or as fair value because the two are the same. The most understandable way to label it would be to match the label used for the subsequent measure. If the subsequent measure will be fair value, describing the initial measure as cost could be confusing, and the reverse could also be true.

6.64 However, the cost or proceeds of an asset or a liability determined according to the fair value of the consideration given or received can differ from its fair value at the recognition date in the following circumstances:

(a) situations identified by paragraph B4 of IFRS 13:

(i) if the transaction is between related parties;

(ii) if the transaction takes place under duress or the seller is forced to accept the price in the transaction, for example, because of financial difficulty;

(iii) if the unit of account for the transaction and for determining the fair value differ (for example, this might occur if the price for acquiring a group of assets differs from the sum of the prices of the individual assets); or

(iv) if the transaction takes place in a market other than the principal or most advantageous market.

(b) if a Standard requires cost to include amounts not included in fair value, for example, transaction costs, or to exclude amounts included in fair value.

(c) if an asset is constructed internally, in which case the accumulated cost will equal fair value only by coincidence.

Exchanges of items with different values

6.65 Occasionally, two items of different value are exchanged, presumably because the transaction price is affected by other relationships between the parties or by financial distress or other duress of one of the parties (as noted in paragraph 6.64(a)(i)–(ii)).

6.66 Applying the definition of cost in paragraph 6.38, the 'cost' of the asset acquired, or the proceeds from incurring the liability, could be considered equal to the fair value of the consideration given or received. However, there are problems with that approach:

(a) it could result in a failure to recognise an economic loss or gain (for example, an impairment loss or a gain arising from a bargain purchase). In addition, if an asset were initially measured at more than its recoverable amount, an impairment loss would arise at the next measurement date. Similarly, if a liability were measured initially at less than the present value of the resulting cash flows, a loss would arise at the next measurement date. That could mislead users of financial statements by making it appear that the loss occurred after the transaction instead of as a result of the transaction.

(b) it could result in a failure to recognise an unstated aspect of the transaction (for example, an obligation to provide services, a contribution to equity or distribution of equity, or a payment for past services).

6.67 Consequently, rather than measuring assets or liabilities arising in an unequal exchange at the fair value of the consideration given or received, an entity could:

(a) measure the asset acquired or the liability incurred at fair value, and recognise the difference as follows:

(i) if the transaction is with equity investors acting in their capacity as investors (or other entities within a consolidated group), recognise a contribution to equity or distribution of equity.

(ii) if unstated aspects of the transaction can be identified, account for them. Identifying unstated aspects of a transaction (or verifying that there are no other aspects) may be difficult.

(iii) in other cases recognise a gain or loss on the transaction. This approach is counter to the traditional notion that there should be no 'Day 1' gains or losses on acquired assets or incurred liabilities. Apparent gains or losses on exchanges that involve unequal consideration are unusual. However, they can occur if one party is under duress and is desperate to transact. If that happens, a real gain or loss has occurred and reporting it may provide relevant information.

(b) If the consideration given or received is an entity's own equity instrument, measure that equity instrument at the fair value of the asset received or given, or the fair value of the liability extinguished or incurred. This is consistent with the idea that gains or losses do not arise on an entity's own equity instruments.

Non-exchange transactions

6.68 Assets and liabilities may be recognised as a result of non-exchange transactions, for example:

(a) an asset may be acquired or a liability incurred for no consideration (such as an unconditional gift or grant); or

(b) an asset or a liability may arise from an event other than a transaction (for example, a lawsuit).

6.69 If an entity acquires an asset or incurs a liability for either of the two reasons in paragraph 6.68, the item could be measured at zero, which is indistinguishable from non-recognition. IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* permits that in some cases. However, measuring the item at zero may not provide relevant information. As discussed in paragraph 6.24, unnecessary changes in measurement should be avoided. This suggests that the initial measurement basis should be the same as the subsequent measurement basis. (However, this does not rule out using a current market price such as fair value, or another cash-flow-based measurement, to establish deemed cost if the subsequent measurement is cost-based.)

6.70 Deferred tax assets and liabilities and a few other assets and liabilities recognised because of events other than exchanges of equal consideration are measured using cash-flow-based estimates other than estimates of current market prices. Those measures are discussed in more detail in paragraphs 6.110–6.130.

Internally constructed assets

6.71 The discussion of understandability in paragraphs 6.23–6.25 suggests that an entity should measure an internally constructed asset (an asset constructed by the entity itself) at completion on the same basis as should be used for subsequent measurement. In other words:

(a) at cost, if the subsequent measure of the asset will be based on cost. In this case, a current market selling price should not be used as deemed cost. (If the completed asset were measured at completion at a current market price, the entity would normally recognise a gain when it completes the asset, and that gain would, in effect, reverse subsequently as the entity depreciates the asset.)

(b) at a current market price if the subsequent measure of the asset will be a current market price.

(c) using another cash-flow-based measurement, if the asset will be measured on that basis.

6.72 The alternative view would be that a completed asset is different from an asset under construction. Measuring the asset on its completion date at the price for which it could have been acquired (or sold) would provide information about the efficiency with which the asset was constructed. However, determining that price may not be easy for unique or other custom-made assets. Consequently, this approach may not be possible for many internally constructed assets.