Memo

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Introduction

1. This paper describes general principles for determining changes in carrying amounts. The methods discussed—market exit prices, adjusted transaction prices, and other cash-flow-based estimates—were identified as possible candidates at the February 18, 2015 Board meeting. Each FASB member has read these principles and provided comments to the staff. The comments received on these principles are summarized at the end of this paper. No technical decisions have been made on the content of this paper. This paper describes the FASB's most recent discussions about measurement. The FASB's other discussions have been summarized at IFAS meetings.

2. This paper accumulates general statements about different ways of determining carrying amounts that either seem to be self-evident based on the objective of financial reporting or have proved useful in the past, or both. The Board has considered most of the matters addressed by those statements in past standards-level decisions (though not necessarily in a systematic or organized way) and is likely to consider them in the future whether or not they end up in a Concepts chapter.

3. The list starts with overall statements; the others address individual methods that are grouped under appropriate headings. None of them address impairment or any other types of changes in carrying amounts that occur only if triggered by events or changes in

circumstances. Those changes will the subject of a separate memorandum for a future meeting.

4. No attempt has been made to prioritize these possible principles. Nor is any future attempt planned to prioritize these or any other statements/principles in a way that would result in automatic or presumed decisions. Some of the factors mentioned may conflict and are likely to be weighted differently in different sets of circumstances. In addition, other factors, such as the cost constraint, must be considered.

5. To the extent possible, these statements have been worded to apply to both assets and liabilities, but the application will differ. Assets are more likely to be marketable than liabilities, and have more variability in the ways in which they can affect future cash flows.

General Principles

Definitions of Terms and Explanation of Phrases

6. The following terms and phrases are used with specialized meanings in this paper.

Estimation Uncertainty

7. *Estimation uncertainty* refers to the fact that an accounting estimate may not approximate the amount that would best meet the estimate (but unknown) amount. Estimates made for the purpose of determining carrying amounts are based directly or indirectly[1] on anticipated future cash flows. Two factors affect uncertainty. One is the width of the range of possible outcomes and the other is the probability of each individual outcome within that range.

[1] Discounted cash flow techniques are based directly on anticipated cash flows. Techniques that involve comparison with similar instruments (or combinations of instruments that in total have a similar outcome) are based indirectly on anticipated cash flows.

Uncertainty Discount or Premium

8. Uncertainty discount (assets) or premium (liability) is a term invented for this paper. It refers to market participants' demand for compensation for bearing the risk of uncertain outcomes and for lack of marketability or availability of hedging instruments, which forces them to retain the risk assumed. Uncertainty discount or premium is not the same as estimation uncertainty, but it is related. Observable prices usually have uncertainty discounts or premiums but no estimation uncertainty. However, if there are no observable prices, uncertainty discounts and premiums tend to increase estimation uncertainty, especially in times of market turmoil.

Cash Flows and Value Flows

9. Although this paper uses the term *cash flows* at least partly out of habit, a better term might have been value flows. Not all of the assets described as producing cash flows actually produce cash. A variety of other types of assets may be received instead of cash without affecting the validity of any of the concepts or principles. The most common alternatives to cash are accounts receivable (or possibly elimination of an accounts payable) and other financial instruments.

Generate Net Cash Inflows (Realize Value) Directly and Indirectly

10. In this context, direct and indirect cash flows are unrelated to the direct and indirect methods in the cash flow statement. Generating cash flows (or realizing value) directly means that the cash flows come directly from the asset, and as the asset is sold or settled (collected), all or a portion of the asset (or sometimes a related accrual-like interest) is derecognized. The carrying amount and changes in the carrying amount often are the most relevant items of information about assets that produce cash flows directly.

11. Generating cash flows (or realizing value) indirectly means that the asset is used to produce a good or service that is sold. That kind of asset is either physical or intangible and is not derecognized as the cash flows in. The carrying amount and the changes in the carrying amount often are not the most relevant information about assets that generate cash flows indirectly. Instead, the effect on income of the net cash flows produced often is more relevant.

12. There is a third "in between" way in which an asset can generate cash flows. The entity can charge others to use it. That includes a variety of things from parking lots and museums to rental property. The cash flows are in a sense direct, but the asset is neither sold nor collected and is not derecognized as the cash flows in. In a sense, the entity is selling a service, but in most cases nothing other than use of the asset is provided. For many in between assets, the carrying amount and changes in the carrying amount are closely related to the cash flows that are produced by charging others to use them. Neither is dramatically more important than the other. For example, if rental real estate is used in its "highest and best" use, it derives its value from the rents it will produce.

13. The categories are to facilitate conceptual discussion. They are not intended to become bright lines for different methods of determining carrying amounts, in part because the line is not bright. The values of almost any asset can generate cash flows directly if the entity chooses to realize its value that way, but the opposite is not true. Some cannot be used to generate cash flows indirectly. Charging for transportation or charging for use of a seat might be considered providing a service. Similar considerations might apply to movies and amusement parks.

14. Liabilities are not divided into similar categories. In all cases, a liability is derecognized as items of value (cash, goods, and services) flow out. In other words, realization of the (negative) value is direct. That does not mean that all liabilities are alike; it means that the directness of value realization is not an important distinguishing factor.

Possible Principles for Determining Changes in Carrying Amounts

15. The following are the statements about relevance and understandability. In all cases, relevance means to be capable of making a difference in resource providers' decisions to buy, sell, hold, extend credit, or settle.

Overall

(a) Changes in carrying amounts usually affect both the balance sheet and the income statement and the relevance of the potential effects on both should be considered when establishing a method of determining changes in carrying amounts. In some cases, the relevance of information in one statement may need to be weighed against possible loss of information in the other statement.

(b) Using fewer, different methods to determine changes in carrying amounts makes financial statements easier to understand. Resource providers need to understand the implications of each change in carrying amount and, in general, as more methods are used, more work is required to understand those implications.

(c) Changing the methods of determining carrying amounts from period to period increases the potential difficulties in understanding the implications of the effects of those changes and impairs comparability between periods. Changes are sometimes necessary to achieve long-term improvements, but unnecessary changes should be avoided.

(d) As estimation uncertainty increases, the relevance of an estimate decreases. That does not mean that uncertain estimates should not be used to determine changes in carrying amounts because they may have more relevance than other available information.

(e) For assets whose values are realized directly, the carrying amount tends to be more relevant than for assets whose values are realized indirectly.

(f) For assets whose values are realized indirectly, the related value flows (revenues and expenses) tend to be more relevant than their carrying amounts.

Entry Prices and Adjusted Entry Prices

(g) Changing carrying amounts to current market entry prices does not provide relevant information about assets the entity already owns unless they are reasonable estimates of market exit prices.

(h) Using experienced entry prices (which generally are presumed to be market entry prices) as initial carrying amounts provide relevant information, but the relevance declines as time passes and market entry prices change.

(i) Systematic allocation of original entry prices may slightly improve the relevance of the resulting carrying amount. However, those carrying amounts do not reflect estimates of cash flows to be generated and provide only indirect information about the remaining life of the asset. Even if those adjusted amounts approximate the market entry price (which is questionable), the market entry price may not be especially relevant information.

(j) The effects on income of systematic allocation usually provide little directly relevant information because they are neither past cash outflows nor indicative of future cash inflows.

(k) Using systematically allocated original entry prices to determine changes in carrying amounts may be justified because the cost is low and the relevance (benefit) of more expensive alternatives is not high. That situation is most likely to exist for assets that are used in production, selling, or delivery or goods or services or to support those activities.

Observed or Estimated Exit Prices

(l) The relevance of a market exit price can be affected by the probability that an asset will be sold or a liability will be settled or transferred at a market exit price. However, the correlation between that probability and relevance is high for some types of assets and liabilities and not high for others.

(m) Market exit prices for financial instruments can provide information about cash flows that will be collected even if the asset or liability has fixed or only slightly variable terms and ultimately is settled according to those terms.

(n) Current entry prices of assets that the entity must replace to continue its operations provide information that is useful if disclosed in notes, but changes in those replacement costs provide little, if any, information about the existing asset or the entity's current operations.

(o) As the probability increases that an asset will be sold or a liability will be settled or transferred at a market price, so does the relevance of the market exit price.

(p) The relevance of market exit prices, by themselves, for assessing effects of assets on prospects for cash flows is inversely related to the cost of selling an asset.

That is, the relevance of market exit prices decreases as cost of selling increases because the net cash flows to be realized from sale diverges from the market exit price.

(q) The relevance of market exit prices for assessing effects of assets on prospects for cash flows may be affected by the uncertainty discounts or premiums, but the effect depends on the probability that an asset or liability will be sold, settled, or transferred at a market price. For assets or liabilities that will be sold, settled, or transferred at market prices, there is no more relevant information than market exit prices, regardless of the uncertainty discounts or premiums.

Prices Paid or Received After the Reporting Date

(r) If an estimate of a market exit price is needed because prices are not observable at the reporting date, the price paid or received between the reporting date and the date the report is issued may provide information that is useful in making that estimate.

(s) Exit prices paid or received after the reporting date but before the report is issued do not necessarily indicate the price at the reporting date.

Other Carrying Amounts

(t) Current estimates of future cash flows and updates of some, but not all, factors that affect market prices (for example, estimated future cash flows but not discount rates) may provide relevant information for assessing prospects for future cash flows. They are most likely to be useful in circumstances in which (1) the cash flows impounded in market prices are overshadowed by the magnitude of uncertainty discounts or premiums or (2) there are no observable prices and estimation uncertainty is extremely high either because of lack of information or because the uncertainty discount or premium is difficult to determine.

The Effect of the Probability That an Asset or Liability Will Be Sold, Settled, or Transferred at a Market Exit Price

16. If an asset can be used to produce cash flows indirectly or sold to produce cash flows directly, the probable outcome affects the relevance of an exit price.

17. If the market exit price of an asset is directly related to the anticipated future cash flows from operating or collecting an asset, that price can be highly relevant even if the asset is never sold. Some examples are rental property, other assets that the entity charges others to use, and derivative instruments whose ultimate cash flows are highly variable and closely related to the factors that determine their market exit prices.

18. Similarly, the market exit prices of liabilities are highly relevant if their ultimate cash flows are highly variable and closely related to the factors that determine their market exit prices. Derivative instruments, guarantees, insurance policies, and similar contracts are examples.

Finished Goods, Retail, and Wholesale Inventories

19. The considerations that apply to finished goods, wholesale, or retail inventories are different from those that apply to most other types of assets that the entity ultimately will sell. There are a variety of reasons, but the primary issue is when to recognize revenue and profit or loss. One issue is that such assets may deteriorate or otherwise decline in utility or market price simply by being held, and the prospects for selling them may be uncertain. The incremental cost of selling the inventory (for example, storage, display, transportation, and advertising) tends to be higher than the costs of selling other types of assets.

20. On occasion, an entity may have inventory for which demand is so high that it turns over very, very quickly and the incremental selling costs are minimal. In those cases, carrying the inventory at its market exit price would provide relevant information and would not be subject to the same issues as other inventory items. However, even in those circumstances, determining changes in carrying amounts based on market exit prices probably would not be the most useful and understandable way to provide information. First, it would mean that the carrying amounts of otherwise similar inventory would be

determined differently. Second, resource providers traditionally rely heavily on past gross profit margin (adjusted for known changes in prices or circumstances) as an indicator of future prospects, and to recognize a gain or loss prior to sale would change the implications of gross profit margins for some but not all products. That almost certainly would make analysis harder.

Assets That Will Be Sold, That Probably Will Be Sold, or That May Be Sold

21. The only reasons to consider not using observed or estimated market exit prices for determining changes in carrying amounts of assets that probably will be sold or may be sold would be that the cost of making an estimate is especially high or the uncertainty (and, therefore, the risk premium or illiquidity premium) is so high that it overwhelms information about amounts and timings of cash flows.

Assets Used to Produce, Sell, and Deliver Goods or Services and to Support Those Activities

22. Because assets used to produce, sell, or deliver goods or services or to support those activities are not realized directly, the carrying amount and changes in the carrying amount are not the most relevant information.[2] Instead, the most relevant information is provided by the revenues generated by selling the goods or services produced and expenses necessary to generate those revenues.

23. Therefore, systematic allocations may be the best way to determine changes in their carrying amounts. Determining market prices or the entity's estimates of "worth" create expenses that in many cases would not be justified by the benefits to resource providers of receiving the information. It has been stated that some patterns of systematic allocation may produce carrying amounts or changes in carrying amounts that facilitate assessments of management's performance. Even though providing information to assess management's performance is not the objective of financial reporting, it is consistent with the objective because management's competence can be an important determinant of the entity's future cash flows.

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[2]This may not include circumstances in which the asset is not at highest and best use.

Liabilities Whose Apparent Changes in Carrying Amount Result Partly from Recognition of New Components or Derecognition of Previous Components

24. Some liabilities, such as pensions and other employee benefit plans, asset retirement obligations, and a few others, may appear to be a single obligation but actually represent a combination of many individual obligations. Liabilities of that type raise significant issues because the change in the line item is composed of at least three parts:

    (a) The effects of determining initial carrying amounts of newly recognized liabilities

    (b) Settlement or other elimination (for example, forfeiture) of all of a portion of previous individual liabilities

    (c) Changes in the carrying amounts of previous liabilities that have not been settled.

25. Carrying amounts or changes in carrying amounts of the different components might conceptually be determined differently. However, for practical reasons, such as difficulty in measuring or even identifying individual components, single "short-cut" methods sometimes have been applied to the entire balance. The Board will always face such difficulties, which is why concepts do not result in automatic answers to standard-setting questions.

Comments from the Board on General Principles That Require Further Discussion

26. The four specific matters that seem to require further discussion involve the following:

    (a) Market exit prices for items that are not expected to be sold

    (b) Estimated market prices

    (c) Changes in carrying amounts of inventories

    (d) How using different methods of determining changes' carrying amounts affects understandability.

27. Three of those four matters relate directly to market exit prices, the use of which has been controversial for many years.

Market Exit Prices for Items That Are Not Expected to Be Sold

28. Some Board members made a general comment that market exit prices are not relevant for items that are not expected to be sold. A significant issue is that in many cases, no one can know in advance whether or not an item will be sold. Plans change regularly as management identifies new or additional opportunities or risks (and they should). The 20-year history of issues with tainting and held-to-maturity securities is evidence of that fact.

29. Some Board members commented that the listed principles give the impression of being skewed toward current market exit prices in general, and we may be able to counter that with some careful wording changes. However, based on long history of input from resource providers and on the logic of financial statement analysis, it would be impossible to justify a statement about any particular class of assets that a current market price has no relevance. The statement in paragraph 15(g) of this paper acknowledges that there is very little relevance in some cases. If we can identify other specific circumstances other than simply management intention, it would be appropriate to add them to the list of principles.

Estimated Market Prices

30. A few Board members stated that market exit prices estimated by management do not provide information about market participants' views. That comment has merit, but as stated it is too broad. It does not apply equally to all estimated market prices, and there probably are not many estimated market prices that provide no information at all that would be relevant to resource providers.

31. Estimates made using prices of closely comparable items or using observable market information for all significant inputs certainly provide information about market participants' views. At the other end of the scale, estimated market prices are likely to provide little or no useful information about market participants' views if the significant (critical) inputs must be estimated by management without help from observations. The level of information provided by an estimate varies between those two extremes.

32. For most assets and liabilities held by an entity, the entity itself is, was, or will be a market participant. Therefore, management probably has at least some information about what

would be a market participant's view. Resource providers whose only source of information about those assets or liabilities is the entity's financial statements may benefit by even the limited information at management's disposal.

33. The measurement chapter of Concepts Statement 8 can certainly acknowledge those points. Paragraph QC16 of Concepts Statement 8 (which is in Chapter 3) states the following:

> A faithful representation, by itself, does not necessarily result in useful information. For example, a reporting entity may receive property, plant, and equipment through a government grant. Obviously, reporting that an entity acquired an asset at no cost would faithfully represent its cost, but that information probably would not be very useful. A slightly more subtle example is an estimate of the amount by which an asset's carrying amount should be adjusted to reflect an impairment in the asset's value. That estimate can be a faithful representation if the reporting entity has applied properly an appropriate process, described properly the estimate, and explained any uncertainties that significantly affect the estimate. However, if the level of uncertainty in such an estimate is sufficiently large, that estimate will not be particularly useful. In other words, the relevance of the asset being faithfully represented is questionable. If there is no alternative representation that is more faithful, that estimate may provide the best available information.

34. The measurement chapter can build on that point by more directly referring to estimates of market prices. (As an aside, the wording of the next to last sentence in paragraph QC16 of Concepts Statement 8 is poor. It should have said that the information about the asset is of questionable relevance rather than referring to the asset itself.)

35. One possible additional principle to acknowledge the point behind those comments would be something like the following:

> The amount of information about market participants' views conveyed by an estimated market price depends on how closely the inputs are based on information that is determined based on observed market transactions. The more an estimate is affected by information developed without benefit of observation, the more uncertain the estimate becomes and, therefore, its relevance declines relative to estimates with inputs based on observations.

How Using Different Methods of Determining Changes' Carrying Amounts Affects Understandability

36. One Board member made a comment that using too few measurement methods could make a set of financial statements less understandable. That comment was in response to the principle in paragraph 15(b).

37. It does not seem possible that using fewer methods could reduce understandability. Using a single method for the entire set of financial statements would seem to make them easier to understand, not harder, and the totals would be more meaningful. That may not necessarily provide the most relevant information or the type of information some would want or expect to see, but it is difficult to see how that would be hard to understand.

38. Another Board member commented that using more than one measurement method in a single line item was the most important issue. Certainly, that is an issue, and adding that comment to the principle in paragraph 15(b) would be easy if other Board members believe that it is appropriate.

Some Remaining Issues to Be Resolved

39. The following issues related to historical cost still need to be resolved at future Board meetings:

    (a) When do we remeasure cash flows vs. allocate initial carrying amounts?

    (b) How do we determine how to allocate?

    (c) When do we discount and at what amount? When do we update discount rates, if at all?

    (d) How do we identify impaired assets and to what amount do we adjust them once identified?

    (e) What prices or costs go into the determination of initial carrying amounts?