# IASB Conceptual Framework
# Measurement

## Objective

1 The purpose of this paper is to provide guidance on how Chapter 6 *Measurement* in IASB Exposure Draft *Conceptual Framework for Financial Reporting* ('the ED') could easily be expanded to meet the concerns raised by EFRAG in its comment letter on the ED.

2 This paper is limited to the contents of Chapter 6 of the ED. It does not address other concerns raised by EFRAG – most notably the reporting of performance and the distinction between profit or loss and OCI.

3 EFRAG's proposals fall into the following areas of the proposed measurement guidance:

(a) Description of historical cost;

(b) Customisation;

(c) Description of current value – advantages/drawbacks of the use of fair value or of an entity specific value;

(d) Selection of a measurement basis: relevance; and

(e) Selection of a measurement basis: business model.

## Description of historical cost

4 EFRAG agrees with the description of historical cost provided in paragraph 6.7 of the ED. In EFRAG's view historical cost reflects the transactions undertaken to acquire or construct an asset and therefore is entity specific. It follows that the historical cost of a non-financial asset at the time of the asset's acquisition or construction is the value of all the costs incurred, *without restatement for prices changing during the process of acquiring or constructing the asset*, including both the consideration given and the transaction costs incurred.

5 As stated in paragraph 6.17 of the ED, measurement at historical cost can result in similar assets or liabilities acquired or incurred at different times being reported in the financial statements at different amounts. Some argue that this reduces comparability between reporting entities and from period to period within the same reporting entity. However, measurement of similar assets and liabilities at historical cost provides information about the impact on profitability caused by different times and/or methods of acquisition of assets or incurrence of liabilities. This impact may be relevant information to users.

6 **EFRAG recommends** that the ED should be amended to clarify that historical cost does not lead to restatement of any of the inputs into historical cost.

## Customisation

7 The ED proposes to classify measurement bases as either historical cost or current value. Further, it notes that "In practice, to provide the most useful information, value in use and fulfilment value may sometimes need to be customised" (paragraph 6.35). However, the ED does not explain when, and why, customisation would be useful.

8 A current value measurement would be expected to update all inputs at the reporting date. Customisation applies when circumstances arise where more

useful information is provided by updating some, but not all, of the inputs, for example not updating interest rates.

9 For this purpose, **EFRAG recommends** that it could be useful for the Conceptual Framework to describe what each of the inputs in a current value measurement represent. In making its standard-setting decisions in the future, considering how to enhance the relevance of financial reporting in both the statement of financial position and the statement(s) of financial performance, the IASB could refer to these descriptions to assess whether to customise a measurement basis. The intent in providing these descriptions is not to encourage customisation beyond well identified needs. EFRAG agrees that unnecessary proliferation of different measurement bases is best avoided.

**Description of current value – advantages/ drawbacks of the use of fair value or of an entity-specific value**

10 The ED, in paragraph 6.20, separates current value measurement bases between fair value and entity-specific values (value in use for assets and fulfilment value for liabilities). The ED considers that value in use and fulfilment value reflect the same factors as fair value, but are based on entity-specific assumptions instead of assumptions by market participants.

11 The ED proposes that fair value information about assets and liabilities has predictive value (paragraph 6.28), because fair value reflects market expectations about the amount, timing and uncertainty of the cash flows. However, EFRAG considers that this predictive value only arises when market participants' expectations are consistent with the entity's activities because the actual cash flows (as distinct from the possible cash flows) depend on how the entity expects to realise the value in an asset. Whilst the ED states that fair value would enhance comparability within the entity and between reporting entities, EFRAG believes that this statement applies only in circumstances when fair value is deemed relevant considering an entity's business activities. When business activities lead to different cash-flow expectations, using the same measurement basis may hide dissimilarities that would be best made apparent to users.

12 Similarly, measurement of liabilities at fair value would bring predictive information only in circumstances where liabilities are expected to be discharged to a third party. In circumstances where liabilities are expected to be fulfilled by the entity, it might not be relevant to reflect the effect of the own credit risk of the entity.

13 EFRAG acknowledges, however, that fair value may reduce subjectivity in the estimates provided (unless measured at Level 3 of the fair value hierarchy) and therefore be considered more representationally faithful by users than an entity-specific value. Some trade-off between relevance and faithful representation may therefore lead to choosing fair value instead of an entity-specific value, provided that the market participant's view is reasonably consistent with the entity's business activities.

14 Some also argue in favour of the use of fair value because it would lead to a more favourable cost/benefit trade-off. EFRAG considers, however, that the costs of applying an entity-specific measurement will only be higher than the cost of fair value when market prices are observable.

15 EFRAG further notes that fair value measurements may also have confirmatory value when market price changes are directly relevant to the performance of the entity.

16 **EFRAG recommends** that the description of current value be modified to reflect all of the above. As currently written, the standard-setter may be led to requiring fair value even though a market value may have only a low probability of being realised, whereas an entity-specific value may have greater predictive value.

**Selection of a measurement basis: relevance**

17 Although the ED acknowledges that, when selecting a measurement basis, it is important to consider what information that measurement basis will produce in both the statement of financial position and the statement(s) of financial performance, the further discussion in the ED on relevance focuses on assets and liabilities.

18 **EFRAG recommends** that in the first place the selection of the measurement basis should be considered from the perspective of reporting financial performance. This approach has the benefit that the measurement basis used for financial performance is assessed in its own right rather than being an outcome of the measurement bases used for the statement of financial position.

19 Generally, the measurement basis used for financial performance should be used for the measurement of assets and liabilities in the statement of financial position. However, when more relevant information can be provided in the statement of financial position by selecting different measurement bases, consideration should be given to either:

(a) Requiring different measurement bases to be used in statement(s) of financial performance and in the statement of financial position. This would apply when the incremental relevance is significant enough to warrant the additional complexity of dual measurement; or

(b) Requiring the measurement basis that is most relevant for the statement of financial position to be used in the statement(s) of financial performance. This would apply when the measurement basis used for the statement of financial position is acceptable (even if not preferred) from a performance reporting perspective. That is, this approach would be used when the loss of relevance of financial performance measures is largely outweighed by the gain in relevance in the financial position measures.

**Selection of a measurement basis: business model**

20 The ED states that, to produce relevant information, it is important to consider how an asset or liability contributes to future cash flows.

21 In the view of EFRAG, and following from the view expressed in paragraph 14 above, the business model should play a significant part in the selection of the measurement basis. It is the business model that will determine whether the cash flows will arise from use in operations or from trading. Unless the business model is considered, the cash flows that could be expected from the measurement basis may be more hypothetical than real.

22 It follows that differences in business activities would result in similar assets and liabilities generating differences in the amount and timing of cash flows. **EFRAG recommends** that this should be reflected in financial reporting and the guidance in the Conceptual Framework should be expanded. For example:

(a) If an asset is used on a stand-alone basis and returns to the entity are entirely derived from changes in market prices, fair value provides relevant information for the depiction of an entity's performance and financial position.

(b) If an asset is held both to receive periodic income and for capital gains, periodic fair value changes might not appropriately reflect the cash-flow profile derived over time from the asset. From a performance reporting perspective, it could be relevant to isolate changes resulting from a cost-based measurement of the asset from any potential capital gain or loss. However as capital gains are realised through sale, fair value measurement in the statement of financial position could provide relevant information about the ability of the assets and liabilities to generate cash flows on disposal or settlement.

(c) If an asset is used on a stand-alone basis or in conjunction with other assets and liabilities within the operations of the entity, inputs being transformed, combined to generate goods or services or simply transferred from one market to another market, the value created is the difference between the prices of the inputs and the income that is derived from the sale of the outputs to customers or third-parties. In such cases, the historical cost measurement basis would be expected to be relevant from a financial performance reporting perspective for both inputs and outputs because it shows the value of the entity's transformation activities. From a financial position perspective, there may be circumstances of no or very low demand risk and of readily observable prices when a current value measurement of outputs could be considered to provide more relevant information than a cost based measurement.

(d) The guidance above could be applied to liabilities in a similar manner; however very few liabilities are discharged to a third-party in a transfer scenario; therefore most often liabilities will be accounted for at amortised cost or on the basis of fulfilment value, depending on the variability of the expected cash-flows.

23 Notwithstanding the role business activities should play in the measurement of assets and liabilities, EFRAG agrees with the role that the characteristics of the instrument should play as stated in paragraph 6.54(b) of the ED.

**Questions for ASAF members**

24 Even if you do not agree with how EFRAG suggests supplementing the measurement guidance, do you agree that the proposals in the ED should be further expanded and explained before the *Conceptual Framework for Financial Reporting* is finalised?

25 If so, do you agree that this supplementary effort need not delay the finalisation of the conceptual framework unduly?

26 Which of EFRAG's proposals do you support and which do you oppose, and why?