Measurement and the Conceptual Framework

Background

1 At its April 2016 meeting, ASAF considered a paper prepared by EFRAG relating to the proposed guidance in the Conceptual Framework on the selection of a measurement basis. This revised paper further considers the issues raised in the April paper, including addressing the comments received at the ASAF meeting.

Introduction

2 The IASB Exposure Draft *Conceptual Framework for Financial Reporting* ('the ED') contains some discussion about the differences between historical cost and current value and the information conveyed by each measurement basis.

3 However, in EFRAG's view, the ED does not provide a sufficient basis for the selection of a measurement basis. Further, the reporting of performance is inextricably linked with the measurement basis used, regardless of whether performance is seen from a narrow perspective (such as limited to profit or loss) or a wide perspective (profit or loss, comprehensive income, financial position and cash flows).

4 Principles for the selection of a measurement basis are needed to ensure consistent standard-setting and to avoid repeatedly re-discussing measurement issues when setting Standards.

5 This paper:

(a) summarises the relevant concerns raised by EFRAG in its comment letter on the ED;

(b) considers whether the principles included in the ED provide sufficient guidance for the selection of a measurement basis;

(c) proposes for inclusion in the Conceptual Framework a guide to the selection of a measurement basis when setting Standards; and

(d) applies that approach to an asset that is not specifically within the scope of an IFRS Standard.

6 The paper is limited to a discussion of assets. In a future paper, the proposals could be extended to consider liabilities, and the interaction between certain assets and certain liabilities.

Concerns raised by EFRAG in its comment letter on the ED

7 Although EFRAG broadly agreed with the IASB's views on measurement as set out in the ED, the EFRAG comment letter also noted that:

(a) the business model should play an important role in selecting the appropriate measurement basis;

(b) limiting the number of measurement bases could conflict with the objectives of financial reporting; and

(c) the mere mention in the ED of factors to be taken into account when selecting a measurement basis without much additional sense of direction is insufficient. EFRAG considered that "the IASB could usefully build on the description of different measurement bases to determine the necessary guidance, distinguishing clearly between what is useful to the statement of financial position on the one hand and to the statement(s) of financial performance on the other. As a result, the Conceptual Framework should include guidance on:

(i) How to select measurement bases that are useful for reporting both the financial position and the performance of the entity;

(ii) When to select between market-consistent and entity-specific measurement bases; and

(iii) When customisation of measurement bases could be useful."

The principles included in the ED

8 The ED proposes that the qualitative characteristics of useful information and some other factors should be considered in selecting a measurement basis. Further, the ED states that initial measurement and subsequent measurement should be considered together.

9 The factors discussed in the ED are:

(a) Relevance: which includes consideration of how that asset or liability contributes to future cash flows, which will depend in part on the nature of the business activities conducted by the entity, the characteristics of the asset and the level of measurement uncertainty in estimates of the information provided by the measurement basis. (In EFRAG's view consideration should also be given to whether the resulting information is useful for decisions about stewardship.)

(b) Faithful representation: similar measurement bases should be used for related assets and liabilities.

(c) Enhancing characteristics – comparability, verifiability and understandability: use measurement bases that result in measures that can be independently corroborated, avoid a proliferation of different measurement bases and retain the same measurement basis over time.

(d) Factors specific to initial measurement: none of these are relevant to the case under consideration.

10 These criteria may, however, point in different directions and may thus not provide useful guidance for the selection of a measurement basis. The measurement bases and reasons why they might be selected are as follows:

(a) Historical cost: the purchase price provides information about the asset that has been acquired. Consideration would then need to be given to impairment and (possibly) amortisation/depreciation.

(b) Fair value: this shows how the market would value the asset and would be impacted by asset- and entity-specific factors such as the condition of the asset and external factors such as the overall economy and its impact on the way the asset is to be used.

(c) Value in use: this provides information about the entity's planned use of the asset in the short-, medium- and long-terms.

11 Without contacting users and discovering what information they require for their purposes (assuming that all users want the same information), the guidance above provides no compelling reason to prefer a particular measurement basis for a

particular item. It is for this reason that EFRAG considers that the measurement guidance included in the ED is insufficient and does not meet the objective of the (revision of the) Conceptual Framework.

Additions to the Conceptual Framework to meet EFRAG's concerns

12 This paper proposes the following additions to the Conceptual Framework in order to address some of the concerns outlined in its comment letter on the ED:

(a) In relation to the discussion of relevance (see paragraph 9(a) above), considering the business activities conducted by an entity will require acknowledging that similar assets can play different roles for different entities, with a consequent impact on cash flows and the reporting of performance. Within the context of an entity's business activities, the different roles of an asset can include:

(i) The asset is part of the entity's trading activities and the entity purchases and sells it on the same or a similar market. The entity is thus using the asset to generate profit from speculating in price fluctuations.

(ii) The asset is part of the entity's trading activities and the entity purchases the asset in one market and sells it in another market (including production) (e.g. most inventory). That is, the entity is using the asset to generate profit from the price differential between the markets (and value added by production).

(iii) The asset is used within the entity's operations. This includes operating assets such as property, plant and equipment and many intangible assets. The entity generates profit from using the asset, often in combination with other assets.

(iv) The asset has been used within the entity's operations, but is now to be disposed of and may generate cash inflows (such as through disposals of property, plant and equipment). Income from disposal is (most often) secondary to the original purpose of using the asset in operations.

(v) The asset is held to generate periodic returns overs its useful life or until maturity. The cash flows may be determinable and thus not affected by market movements.

(vi) The asset is held to generate both periodic returns and capital gains. Separately recognising periodic returns and holding gains and losses may provide information about performance and the effect on financial position.

(vii) The asset is held because of regulatory requirements related to a business activity that is carried out by the entity.

(viii) The asset is held for the purpose of managing risk (resulting from the entity's business activities). Measuring the asset in a way that matches the applicable risk may provide information about the entity's risk management activities.

(b) When considering the information that would be most relevant for performance reporting purposes (see paragraph 9(a) above), consideration should be given to when and where changes in value should be reported. For example, short-term changes in value such as the changes in the value that arise because the entity is acquiring an asset in one market and selling it in another market would usually be included in the profit or loss on disposal. On the other hand, if the asset is bought and sold in the same or similar markets and the entity's objective is to generate returns through longterm changes in value, reporting value changes in each period may provide more relevant information than reporting the entire holding gain or loss only when the asset is derecognised.

(c) When assessing the most relevant information about how an asset contributes to future cash flows (see paragraph 9(a) above), the relationship between the contractual cash flows and the expected actual cash flows should be taken into account, if relevant. If an asset is a contract with specified contractual cash flows, and the entity expects to collect those cash flows (e.g. a fixed interest rate loan that the entity will hold to maturity), there may be limited benefit in measuring it at current value.

(d) When considering how relevant information from a stewardship perspective can be provided (see paragraph 9(a) above), it should be assessed whether management's performance is better reflected by reporting changes in value when realised (i.e. using historical cost) or during the holding period (i.e. using current value). An assessment should also be made as to whether management is accountable primarily for the amount invested (i.e. cost) or for the value of assets under their stewardship (i.e. current value).

(e) In accordance with paragraph 9(b) above, consideration should be given as to whether either historical cost measurement or current value measurement are unlikely to be capable of providing a faithful representation. This would include assessing the extent of measurement uncertainty.

(f) The consideration of comparability (see paragraph 9(c) above) would mean that a change in the measurement basis of a particular asset (or liability), or the selection of a measurement basis that is different from similar types of assets (or liability) (considering how the asset (or liability) is used by the entity) has to provide sufficiently improved information.

13 In some cases the measurement basis that best reflects financial performance may differ from the measurement basis that best reflects financial position. In those cases:

(a) If a compromise between the two can be found, that compromise should be selected; and

(b) If a compromise between the two cannot be found, financial performance and financial position should be measured on different bases with an adjustment in other comprehensive income or elsewhere.

14 In cases where historical cost is considered to provide the most useful information for reporting performance, it should also be assessed whether historical cost provides useful information for assessing future cash flows for the purpose of the statement of financial position. In many cases, there is some relationship between historical cost and current value. However, this is not always the case. For example, in the case of derivatives (if they were to be measured at historical cost in the statement of financial performance), some property, plant and equipment such as land which has been held for a long time or reserves in the extractive industries, historical cost may not provide useful information about the cash flows arising from the economic benefits embodied in the asset.

15 If the above issues lead to a view that a current value measurement basis provides the most relevant information, it is then necessary to consider whether fair value (the market perspective) or value in use (the entity perspective reflecting the cash flows expected by the entity) provides more relevant information. Fair value is likely to provide more relevant information for assets that are to be traded, whereas value in use is likely to provide a better representation of expected future cash flows for assets that are to be used and liabilities that are expected to be fulfilled.

16 When a current value measurement has been selected, it should also be assessed whether a single characteristic of the asset should dominate the measurement regardless of the purpose of holding the asset. For example, it should be considered whether the measurement of biological assets should be solely driven by biological change.

17 These proposed additions to the Conceptual Framework are designed to provide a framework for decisions on the selection of a measurement basis in particular circumstances. The proposals cannot remove the need for judgement when applying the Conceptual Framework. What they can do is to provide more guidance to support the process of making that decision.

Application of the proposed approach

18 As mentioned in paragraph 4, to assess whether the proposals are operational, they will be applied to an asset that is not specifically within the scope of an IFRS Standard. The following example will therefore be considered[1]:

An entity purchases a young, fully grown horse with the intention of training it for racing. If the horse is successful in major races, the entity plans to sell it to stud, potentially at a significant increase over the cost. In the more likely case that the horse is not successful in major races, it would not have a significant resale value and might be retained as a mascot or sold to a riding school.

19 This case leaves two questions to be resolved:

(a) How will the horse contribute to cash flows based on the entity's business activities? Most likely through prize money less the expenses related to training and maintenance and potentially through sale to stud; and

(b) How does this assist in selecting a measurement basis?

	Financial performance	**Financial position**
	HISTORICAL COST	
Information produced	Income: prize money earned plus sales proceeds when realised. Expense: training costs etc., depreciation representing periodic consumption of economic benefits embodied in historical cost.	Purchase price, less depreciation and impairment (if applicable).
Relevance	Information provided would be relevant in assessing the entity's ability to select, train and place its racehorses.	Historical cost-based carrying value may be of limited relevance of itself in estimating future cash flows. However, this assessment should consider how users would actually seek to predict future cash flows given this type of business activity. Historical cost-based carrying

[1] The example is only included in this paper to assess whether the proposals are operational. It is not the intention that the example should be included in the Conceptual Framework.

	Financial performance	Financial position
		value may be relevant for the assessment of **stewardship.**
Faithful representation	Depiction of entity's earned income and incurred expenses would be faithfully represented. The gains generated from the sale of the most successful racehorses to stud would be reported only on sale. This could be viewed as faithful representation of the transaction in view of the high degree of uncertainty of that outcome.	Historical cost-based carrying value would faithfully represent the purchase price less consumption (or diminution through impairment) of the benefits embodied in that amount.
Enhancing qualitative characteristics	Would information be: • Verifiable: yes • Comparable: yes (e.g. with other entities with similar business activities) • Understandable: yes.	Would information be: • Verifiable: yes • Comparable: maybe not, horses with similar carrying values may have very different levels of ability and value/potential • Understandable: yes.
	CURRENT VALUE	
Information produced	<u>Income:</u> prize money earned plus/minus increases/decreases in current value. <u>Expense</u>: training costs etc.	Current value (most likely fair value measured at estimated sale price in principal or most advantageous market for the racehorse at the reporting date).
Relevance	Information provided would aim to report the entity's success in adding value to its racehorses. The relevance of this is limited as most horses are not sold in their current condition.	Ability to sell racehorse at an advantageous price depends on its future performance and current value may not be predictive of future cash flows. Current value may provide relevant information about the stewardship of management in the selection and management of the racehorse.
Faithful representation	Questionable: lack of active market for non-stud ready racehorses may give rise to estimation uncertainty of such significance that it calls into question the practical ability to faithfully represent current value.	Questionable: lack of active market for non-stud ready racehorses may give rise to estimation uncertainty of such significance that it calls into question the practical ability to faithfully represent current value.

	Financial performance	**Financial position**
Enhancing qualitative characteristics	Would information be • Verifiable: challenged by lack of active market for racehorses not saleable to stud • Comparable: yes, in principle • Understandable: may require detailed disclosures to explain basis of valuation.	Would information be • Verifiable: challenged by lack of active market for racehorses not saleable to stud • Comparable: yes, in principle • Understandable: may require detailed disclosures to explain basis of valuation.

20 Based on the above analysis, historical cost would be selected for both financial performance and financial position because of the limited relevance and questionable faithful representation provided by the use of a current value.

21 However, had the facts and circumstances been different, the proposals could result in another measurement basis being selected. For example:

(a) Had the entity bought a racehorse with the intention of gaining on short-term fluctuations in its price (basically trading activity on the same or a similar market) and had there been a liquid market for racehorses, no significant selling efforts and reliable market prices, the proposals could result in the racehorse being measured at a current value (and, in this case, probably fair value).

(b) There could also be cases where it could be most useful to measure a racehorse at a current value in the statement of financial position, but with the changes in the current value being reported in OCI (until the racehorse is sold). This could have been the case, for example, if the focus of the entity was not on training a racehorse to maximise its earnings through racing but instead on selling the horse (at the right time) and the receiving the prizes the horse would collect (holding an asset for periodic returns and capital gains). In this case, the information about the current value in the statement of financial position could be relevant. However, depending on what 'profit or loss' is determined to represent, it might only be relevant to report income from prizes and from selling the racehorse in profit or loss.

22 Paragraph 21(b) acknowledges that (sometimes subtle) differences in the way that otherwise similar assets are used by an entity could lead to different conclusions in the selection of a measurement basis. Nonetheless, we acknowledge that it may not be practical or desirable to accommodate every subtle difference when selecting a measurement basis at standards-level.

Question for ASAF members

23 Do you consider that the proposals in paragraphs 12 - 16 of this paper would go some way to meeting concerns about the need for more guidance on the selection of a measurement basis than proposed in the Conceptual Framework ED?