STAFF PAPER

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REG IASB Meeting

Project	Conceptual Framework		
Paper topic	Measurement – Use of a single or default measurement basis		
CONTACT(S)	Rachel Knubley	rknubley@ifrs.org	+44 207 246 6904

Purpose of paper

1. When you discussed the strategy for the measurement section of the Exposure Draft in April 2014, you tentatively decided not to undertake significant additional research work on measurement. In particular, you considered approaches suggested by some respondents to the Discussion Paper which would require the use of a single or default measurement basis, and tentatively decided not to develop any of those approaches. However, the staff undertook to provide you with a paper that:
   (a) describes the approaches suggested by respondents;
   (b) discusses their advantages and disadvantages.
2. The purpose of this paper is to provide you with the analysis that we promised in April. Given your tentative decision not to develop in detail these approaches, this paper is primarily for information only. However, at the end of the paper we ask you to consider whether the discussion in this paper causes you to reconsider your decision not to develop these approaches further.
3. In this paper we:
   (a) Discuss the use of a single or default measurement basis (paragraphs 4 - 9);
   (b) Discuss the advantages and disadvantages of using a current rather than historical measurement basis (paragraphs 10 - 12);

(c) Describe the different approaches to measurement proposed by respondents to the Discussion Paper (paragraphs 13 - 35).

Use of a single or default measurement basis

4. The approaches to measurement discussed in this paper would require either the use of a single measurement basis or the selection of a default measurement basis.

5. The advantages of a mixed measurement approach are discussed in AP 10C – *Selection of a measurement basis*. In contrast, the main advantages of a single measurement basis are:

   (a) The amounts included in the financial statements can be more meaningfully added, subtracted and compared.

   (b) A single measurement basis makes the financial statements less complex and (arguably) more understandable.

6. Most of those who expressed support for a single measurement basis conceded that this would be unlikely to be achieved in practice (at least in the short term) However, they expressed the view that the *Conceptual Framework* should aspire to a single measurement basis (ie the IASB should describe a default measurement basis). Departures from the preferred or default measurement basis would be permitted (for example, for cost-benefit reasons, if the measurement basis used in a particular case results in a reasonable approximation to the preferred measurement basis or if a different measurement basis clearly provides more useful information).

7. Those who support the use of a default measurement basis argue that it would make the development of measurement requirements for new Standards simpler, more consistent and understandable.

8. In their comment letter, the Australian Accounting Standards Board (AASB) advocated the use of a single measurement basis. They suggested that a single measurement basis could be derived if the IASB identified an ideal concept of wealth that would meet the information needs of users of financial statements.

9. The following table summarises the three ideal concepts of wealth identified by the AASB and the resulting measurement basis:[1]

Concept of wealth	Description	Derived measurement basis
Invested money capital	For assets – original amount invested adjusted for consumption For liabilities – unearned or unrepaid portion of original proceeds	Historical cost
Operating capability	Represents an entity's ability to carry out its activities on the same scale Assets are measured at current cost Liabilities are measured at the current cost of the assets the entity expects to consume in extinguishing the liabilities	Current market entry prices
Current cash equivalents commanded	For assets – the net amounts for which the assets could be sold in an orderly transaction For liabilities – the amounts for which they could be redeemed or transferred in an orderly transaction	Realisable (settlement) value

Advantages and disadvantages of a current measurement basis

10. Each of the single or default measurement bases described in this paper, with the exception of historical cost, is a current measurement basis. Most of the

[1] The AASB went on to argue that the ideal concept of wealth adopted by the IASB should be the operating capability concept of wealth. Hence, the default measurement basis should be based on current market entry prices.

advantages and disadvantages of these approaches are the same as the advantages and disadvantages of any current measurement basis.

11. The main advantages of using a current measurement basis are that:

    (a) Current measurements reflect current conditions and hence may sometimes be more relevant than information based on historical costs;

    (b) The current value of an asset of liability does not depend on when that asset or liability was acquired– resulting in greater comparability between entities. (Comparability is further enhanced if current market prices are used rather than entity specific values.)

12. The main disadvantages of using a current measurement basis are that:

    (a) Determining current values can be costly and complex;

    (b) For some items, current value may be difficult to verify and may require significant judgement (resulting in significant measurement uncertainty).

    (c) Some gains and losses arising from changes in current values can be difficult to understand. In particular:

        (i) Some gains or losses may never be realised;

        (ii) Some gains or losses reverse systematically over time (for example, fair value changes on debt securities that are held to maturity).

Approaches

13. Respondents to the Discussion Paper suggested the use of the following single or default measurement bases:

    (a) historical cost (paragraphs 14 - 17);

    (b) fair value (paragraphs 18 - 22);

    (c) current entry values (paragraphs 23 - 26);

    (d) deprival value/relief value (paragraphs 27 - 35).

Historical cost

14. A few respondents to the Discussion Paper suggested the use of historical cost as the single or default measurement basis (ie historical cost adjusted to reflect consumption, fulfilment, impairment etc).

15. If all assets and liabilities are measured at historical cost an entity's equity reflects the unconsumed historical cost of the entity's recognised assets less the historical proceeds from the entity's unfulfilled recognised liabilities.

16. Those respondents who support the use of historical cost as a single or default measurement basis argue that:

    (a) In many situations, historical cost information is simpler, more understandable and less costly to produce than information using current measurement bases;

    (b) Because only realised gains are reported in comprehensive income, reported gains will not subsequently reverse;

    (c) It results in the more timely recognition of losses than gains [2].

17. However, some of those who support the use of historical cost as the default measurement basis acknowledge that there are situations when it does not provide relevant information (for example, derivatives) and a different (current) measurement basis would need to be used.

Fair value

18. A few respondents to the Discussion Paper suggested that all assets and liabilities should be measured at a current market exit price (fair value).

19. If all assets and liabilities are measured at fair value an entity's equity reflects the net fair value of the entity's recognised individual assets and liabilities.

20. However, because the fair value measurement of each asset and liability does not take account of synergies, the net fair value of the entity's recognised individual

[2] Because historical cost results in the more timely recognition of losses than gains, some respondents describe it as a prudent measurement basis. This description of prudence is different from the description of prudence that you have tentatively decided to include in the revised *Conceptual Framework* (ie the exercise of caution under conditions of uncertainty).

asset and liabilities is not necessarily the same as the fair value of the entity's net assets.

21. Those respondents who support the use of fair value as a single or default measurement basis argue that:

    (a) Because the fair value of an item is independent of when or how that item was acquired (it is a *current marke*t price) identical assets and liabilities are measured identically thereby increasing comparability between entities.

    (b) Because fair value is an exit price, measuring all assets and liabilities at fair value provides information about the outputs from an entity's activities which is potentially more useful for predicting future cash flows than information about inputs (ie entry values).

22. However, the staff note that:

    (a) Use of fair value may obscure information about margins which many users find useful.

    (b) In some situations (for example, when assets generate cash flows in combination), an entity perspective for measurement might help to highlight important differences between entities that fair value measurement might hide.

Current entry values

23. A few respondents to the Discussion Paper suggested that measurement should be based on current entry value.

24. One respondent to the Discussion Paper[3] suggested that assets and liabilities should be measured using current input market values. In particular:

    (a) Assets that are inputs to a cash-generating processes should be measured at current prices in the markets in which they would be acquired by the entity (or, if such prices are not practicable of faithful representation, on the basis of a relevant substitute).

[3] J. Alex Milburn – *Toward a Measurement Framework for Financial Reporting by Profit Oriented Entities*

(b) Business operating liabilities should be measured at current prices in the markets in which the liabilities were issued or incurred (or, if such prices are not practicable of faithful representation, on the basis of a relevant substitute) unless the current market price for settlement prior to maturity is lower and can be achieved without additional cost (in which case the settlement price should be used);[4]

(c) Investing and financing assets and liabilities should be measured at current prices in the markets in which they were acquired, issued or incurred (or, if such prices are not practicable of faithful representation, on the basis of a relevant substitute).

25. If all assets and liabilities are measured using current entry values an entity's equity reflects the current entry value of the entity's recognised assets less the current entry value of the entity's recognised liabilities.

26. Those respondents who support the use of current entry values as a single or default measurement basis argue that:

(a) Such an approach allows users to assess an entity's capacity to sustain its current business model (ie it shows whether income exceeds current costs).

(b) Measuring assets and liabilities at current entry values provides users with information about current margins. Current margins may sometimes be more useful than margins based on historical cost.

(c) Measuring items at current entry values does not result in the recognition of the profit associated with the current exit market.

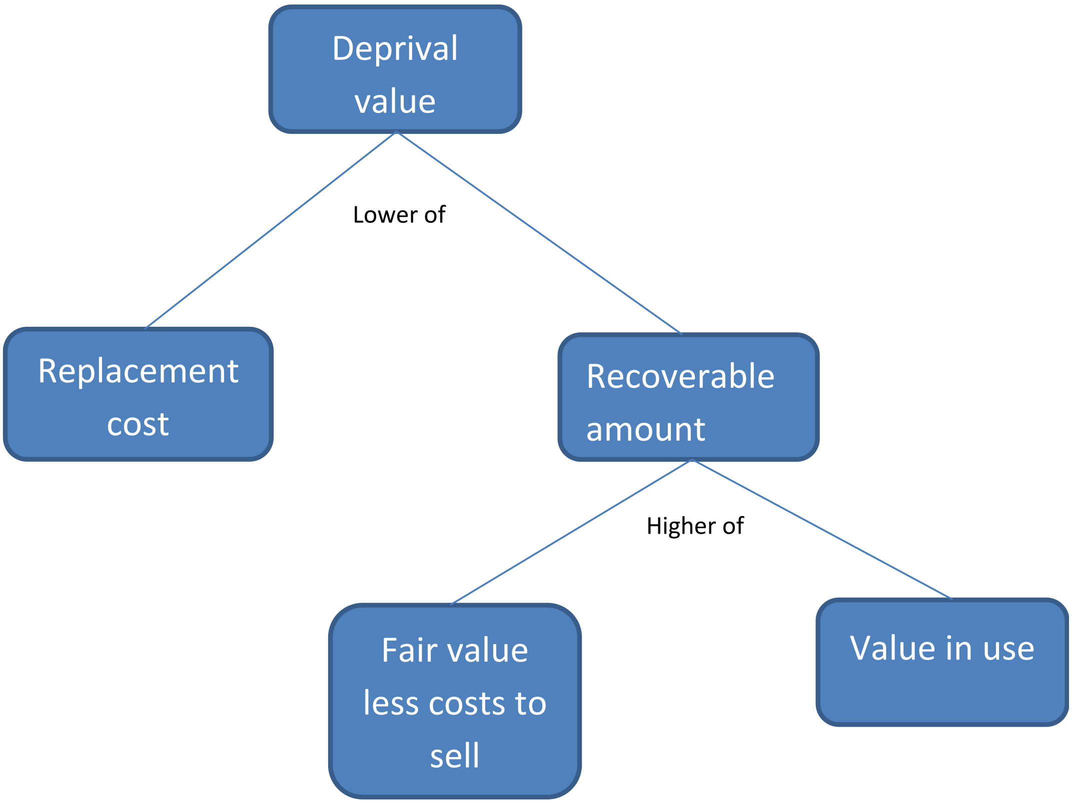
Deprival/relief value

27. A few respondents suggested that all assets should be measured at their deprival value. The deprival value of an asset represents the loss that the entity would suffer if it were deprived of the asset being measured.

[4] The measurement suggested in this comment letter is different from the approach suggested by the AASB in their comment letter. However, both use current entry prices.

28. If the value that an entity can derive from an asset either through sale or use (its recoverable amount) exceeds its replacement cost then, if the entity were deprived of the asset, it would replace the asset, incurring a loss equal to the replacement cost. If, however, the recoverable amount for the asset is less than its replacement cost then, if the entity were deprived of the asset, it would not replace the asset. Instead the entity would incur a loss equal to the amount the entity would have generated from the asset either through sale or use (its recoverable amount).

29. Hence deprival value can be depicted as follows:



30. In many cases, the deprival value of an asset will equal its replacement cost. Only when the replacement cost of an asset is considered not fully recoverable would deprival value be less than replacement cost (in the latter case, deprival value would equal fair value less costs to sell or value in use whichever is higher).

31. The equivalent measurement basis for liabilities is relief value. The relief value of a liability is the benefit an entity would enjoy if relieved of the liability. Relief value is the higher of the assumption proceeds and the settlement amount (the settlement amount is the lower of fulfilment cost and cost of release).

32. Some argue that deprival value/relief value is a measurement basis in its own right. However, others argue that deprival/relief value is not a measurement basis but is instead a systematic way of choosing between different measurement bases.

33. If all assets and liabilities are measured using deprival/relief value, an entity's equity reflects the value of the recognised assets and liabilities to the business.

34. Measuring assets and liabilities based on their deprival/relief value has similar advantages to measuring items based on their current entry values. In addition, supporters of deprival value/relief value state that it better reflects the value of an item to the entity.

35. However, the staff note that:

    (a) determining the different components of deprival/relief value (replacement cost, fair value etc) can be costly and complex; and

    (b) relief value for liabilities may be difficult to understand and implement.

Questions for the IASB

Questions
(a) Do you have any comments or questions on the alternative approaches to measurement described in this paper?
(b) Does any of the discussion in this paper make you want to reconsider your decision not to develop these approaches further?