



**INTERNATIONAL FEDERATION
OF ACCOUNTANTS**

545 Fifth Avenue, 14th Floor
New York, New York 10017
Internet: <http://www.ifac.org>

Tel: (212) 286-9344
Fax: (212) 286-9570

**Agenda Item
2C**

Date: March 17, 2010
Memo to: Members of the IPSASB
From: Andrew Lennard
Subject: Conceptual Framework—Measurement

Objective of this Session

The objective of this session is to **consider** issues related to the measurement phase of the Conceptual Framework project along with a preliminary draft of the Consultation Paper being developed and to **confirm** Staff views or **provide** alternative directions.

Action Required

Members are asked to:

- **Consider** the issues raised in this memorandum and provide direction;
- **Highlight** further issues that are not addressed in this memorandum and **provide** directions; and
- **Consider** the draft Consultation Paper *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: Measurement*;

Agenda Material

- 2C.1 Preliminary draft of Consultation Paper *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: Measurement of assets and liabilities in financial statements*
- 2C.2 A draft issues paper on the measurement of liabilities.
- 2C.3 A draft issues paper on the concept of capital

1 Background

- 1.1 The IPSASB first considered this phase of the Conceptual Framework project at its May 2009 meeting in Washington and subsequently at its September 2009 meeting in Toronto. A further draft was considered by the Conceptual Framework Subcommittee at its meeting in Paris in March 2010.
- 1.2 Following the Subcommittee meeting, material has been prepared on liabilities and on the concept of capital. These are discussed in sections 2 and 3 below.
- 1.3 A number of other changes to the draft Consultation Paper were suggested. These are outlined in Section 4 below, which also provides a possible alternative structure for the paper.

Question for the IPSASB

1 Do IPSASB members have any comments on the direction of travel on this phase of the work on the Conceptual Framework?

2 Liabilities

- 2.1 Although the measurement of liabilities gives rise to many difficult issues, it was the strong view of the Subcommittee that a discussion of liabilities should be included. Agenda Paper 2C.2 provides a discussion of liabilities in the context of the deprival value model. In particular, it tries to demonstrate that it is possible to develop a deprival value approach to liabilities that is consistent with that used for assets.
- 2.2 Staff envisage that liabilities will be discussed in the context of each of the bases of measurement. The discussion in the context of historical cost and market value/fair values is not presented at this meeting. It may be that relatively few unknown issues will arise in that work.
- 2.3 It is relevant to note that whilst the deprival value approach to assets is relatively well established in the literature, it is much less developed in connection with liabilities.
- 2.4 It seems pertinent to compare the draft with the recent IASB exposure draft 'Measurement of Liabilities in IAS 37'. The following specific points may be highlighted:
- (i) The fundamental principle is that liabilities should be stated at the amount the entity would rationally pay to settle (or be relieved of) the liability. This is highlighted in the table paragraph 4 and is consistent with the IASB's exposure draft (paragraph 36A).
 - (ii) In those cases where an exit value (settlement amount) is appropriate, that should reflect the lowest means of settlement. This is also consistent with the IASB's exposure draft.
 - (iii) The draft proposes that a liability that requires work to be done should be measured at the lower of the costs that the entity would incur in doing the work itself or the cost of employing a third party to do so. In contrast, the IASB exposure draft suggests that third party prices should be used, if available, and if not the estimate should be of the price that the entity would charge another party to do the work, including a margin. However, the line taken in the draft is consistent with the Alternative Views of six IASB members as set out in the Exposure Draft.
 - (iv) The draft acknowledges (in paragraph 12) that conceptually the measurement should reflect the riskiness of the liability, but suggests that this is often impracticable, and so a risk-free rate may be used. The Exposure Draft proposes that a risk adjustment should always be made: the six Board members that express an alternative view argue that no

adjustment should be made for risks that are diversifiable, but that an adjustment should be made for non-diversifiable risks.

- (v) The draft suggests (paragraph 13) that it is generally inappropriate to adjust a 'fulfilment amount' in respect of an entity's own credit risk. The Exposure Draft seems not to be explicit on this point. (It may be questioned whether the issue of 'own credit risk' is specific to deprival value and might merit a more general discussion.)
 - (vi) The draft suggests that liabilities which are measured at 'assumption price' will implicitly include the entity's profit, but that it is not appropriate to include a profit margin for onerous contracts. This is consistent with the views of the six IASB members whose 'Alternative views' are set out in the exposure draft. It is also consistent with IASB's proposals on revenue recognition.
 - (vii) The draft questions whether 'assumption price' is relevant for obligations that may arise under non-exchange transactions (paragraph 27). (Staff acknowledge that non-exchange transactions might be discussed earlier and with more prominence.)
- 2.5 Some of these issues are difficult and controversial. It would be impracticable to seek to come to firm views on them at this meeting and staff acknowledge that the meeting materials are, in any event, inadequate for that purpose. Nonetheless, it is hoped that a constructive discussion will identify the initial views of IPSASB members and lines of arguments that need to be explored in the further development of this project.

Question for the IPSASB

- 2 What are IPSASB members' general views on the points listed in paragraph 2.4?**
- 3 What are IPSASB members' views on the paper at 2C.2?**

3 Concepts of Capital

- 3.1 It was the strong view of the Sub-Committee that the measurement chapter should include a discussion of concepts of capital. A draft of such a discussion is set out in paper 2C.3.
- 3.2 As well as discussing the nature of a concept of capital, the draft attempts to clarify the relationship between the various concepts and the financial statements. The implications of the choice of capital concept include, but are not limited to, the preferred basis of measurement for assets (and liabilities).
- 3.3 The draft concludes that it is not necessary to select a single concept of capital but that it is possible—and it hints that it might even be desirable—to use different concepts of capital for different activities, and/or to combine operating and real financial capital concepts within a single set of financial statements.

- 3.4 The draft discussion suggests that, whilst the concept of capital is relevant to measurement issues, it also raises issues of the objective of financial statements, and presentation (and, possibly, the elements of financial statements. An adequate treatment of the topic may require discussion of or reference to the issue in other parts of the Conceptual Framework.

Questions for the IPSASB

- 4 What are IPSASB members' views on the discussion of capital concepts given in paper 2C.3?**
- 5 Do IPSASB members have suggestions for the location of the discussion on capital concepts?**

4 Structure of the Consultation Paper

The current draft

- 4.1 A preliminary draft of the Consultation Paper is at paper 2C.1 Although the foundation for the draft remains that discussed in Toronto last December a number of changes have been made. The IPSASB should note the following:
- The arguments presented in section 2 to support the minimum and maximum amounts are now based on relevance rather than reliability. The previous draft took the view that it would not be representationally faithful to present a line in the statement of financial position that read 'Properties \$100m' if the properties could be sold for \$180m. But this troubled the Board and others, who noted that if the financial statements explained that \$100m were the historical cost, the financial statements might faithfully represent what they purported to represent—i.e. historical cost of \$100m. But many would consider that reporting historical cost would not be relevant.
 - The structure of the paper has been changed as follows:
 - The sections on 'value in use' and 'Impairment of assets and recoverable amount' (previously sections 5 and 6) have been combined, and placed after rather than before the section on 'Market Value' (previously section 7, now section 5).
 - The section on 'Fair Value' has been moved into an Appendix, entitled 'IASB projects on measurement'.
- 4.2 The above changes were made before the subcommittee meeting. Further changes made to reflect the discussion at the subcommittee are:
- The discussion in Section 2 now more prominently focuses on the deprival value model, which is introduced at paragraph 2.3. A diagrammatic overview of the deprival value model is given in paragraph 2.8.
 - The section on Alternative Use assets (paragraphs 4.17-4.21) has been revised. Although the subcommittee felt that the issue should be

addressed in the paper, the thrust of the amendments is to suggest that an incremental value attributable to an alternative use will arise only relatively rarely, should be reflected in the statement of financial position only in restricted circumstances, and in many cases could be best dealt with by supplementary disclosure.

- The discussion on impairment and recoverable amount (Section 6) has been revised. A related issue is discussed in the new paragraph 4.6.
- 4.3 Constraints of time have not allowed all the points made by the subcommittee to be reflected in the present draft and there are some rough edges as a result of failure to make consequential changes. The Appendix to this paper briefly notes the points that remain to be considered and will be reflected in future drafts.

Question for the IPSASB

6 Do IPSASB members' have any comments on the draft at paper 2C.1?

Structure

- 4.1 The staff question whether the structure of the draft in paper 2C.1 is appropriate. This is unsurprising as it is the result of successive changes.
- 4.2 In any event, assuming the IPSASB agrees with the subcommittee, material on liabilities and (at least some of the discussion of) concepts of capital will have to be added. Section 2 now introduces the deprival value model quite early, and some of the previous discussion which was intended to apply generally now relates specifically to deprival value. (This is appropriate given that the general discussion was, to some extent, covert scene-setting for deprival value.)
- 4.3 A further problem with the existing draft is that 'fair value' is discussed only in an Appendix: given its prominence in recent standard-setting activities this may surprise many readers.
- 4.4 Staff would therefore suggest that the structure of the paper is amended along the following lines:
- 1 Introduction
 - As existing
 - Add paragraph s 2.1, 2.2
 - Add introduction to capital concepts.
 - 2 Historical cost
 - As existing section 3
 - Add discussion of liabilities in the context of historical cost
 - Ensure capital concepts are covered
 - 3 Market/fair values
 - As existing section 5
 - Add discussion of fair value, drawing on the Appendix
 - Ensure discussion covers liabilities and capital concepts

- 4 Deprivation value
 - [Most of] 2.3-2.14
 - Add discussion of liabilities in the context of the deprivation value model
 - 5 Replacement cost
 - As existing section 4 including discussion of alternative use assets
 - 6 Impairment of assets and recoverable amount
 - As existing
 - 7 Concluding comments
- 4.5 The above attempts to explain how a new structure might compare to the current draft. It is, however, not intended to suggest that it will simply be a cut and paste of the current draft: there will clearly be consequential changes, and naturally new ideas and material will need to be incorporated.

Question for the IPSASB

- 7 What are IPSASB members' views on the structure set out above?**

Appendix

**Further changes and points to be considered
arising from the meeting of the CF Subcommittee
held in Paris on 6-7 March**

Reference

- | | |
|---------------------|---|
| 1.7-1.8 | Discussion of public sector considerations to be harmonized with discussion in other phases |
| Section 2 generally | Review to ensure that the discussion resonates for financial as well as physical assets. |
| Section 1/2 | Consider introducing notions of entry and exit costs |
| 3.5 | Ensure transaction costs are dealt with under each measurement basis. |
| 7.5 | Add discussion of GFS—the statistical basis of accounting |
| | If profit is to be excluded from (some) liabilities, consider addressing the issue of profit on self-constructed assets |

DRAFT CONSULTATION PAPER CONCEPTUAL FRAMEWORK FOR GENERAL PURPOSE

FINANCIAL REPORTING BY PUBLIC SECTOR ENTITIES:

Measurement of Assets and Liabilities in Financial Statements

1 Introduction

- 1.1 The IPSASB's Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities (the IPSASB Framework) will establish the concepts that are to be applied in developing IPSASs and other documents that provide guidance on information included in general purpose financial reports (GPFRs). The IPSASB Framework will underpin IPSASs that apply across countries and jurisdictions with different political systems and forms of government.
- 1.2 Given (a) the relationship between the IPSASs currently on issue and the concepts and definitions in IFRSs, and (b) the IPSASB's ongoing IFRS convergence strategy, developments in the IASB Framework are being closely monitored. The IPSASB Framework will draw on the work of the IASB where it is relevant to the public sector. An Appendix to this Paper briefly reviews relevant aspects of IASB's current work. However, the objective of the IPSASB's project is not simply to interpret the application of the IASB Framework to the public sector, but rather to develop a public sector conceptual framework that makes explicit the concepts, definitions, and principles that underpin the development of IPSASs.
- 1.3 This Consultation Paper is the third in a series of papers being developed on the key components of the IPSASB Framework. It explores the measurement bases that may validly be adopted for the elements that are recognized in public sector general purpose financial statements (GPFSs). The term 'measurement basis' refers to the concept that is used in determining the amount at which an asset or liability is stated in the GPFSs.¹ Examples of measurement bases are historical cost and replacement cost.
- 1.4 Measurement is an important consideration for GPFSs as the amount at which an asset (or liability) is stated in GPFSs can differ significantly depending on the measurement basis that is used. The choice of measurement basis affects not only the financial position shown in the statement of financial position, but also the expenses and revenue (and hence operating surplus or deficit) reported in the statement of financial performance.²

¹ The term 'measurement basis' is used in this Paper to mean the same as 'measurement attribute'.

² Not all changes in the carrying amount of assets and liabilities are reflected as operating income and expenses. This is a matter that is addressed in the Consultation Paper on 'Presentation and Disclosure'.

Objectives of this Paper

- 1.5 This Consultation Paper explores different measurement bases, their relationship to the objective of GPFs and the qualitative characteristics. This exploration will identify factors that should be considered in choosing the measurement basis to be required for particular assets and liabilities in specific circumstances. The Conceptual Framework will not mandate requirements for the measurement basis to be adopted in specific circumstances. This is dealt with in individual IPSASs which deal with specific transactions and events and are themselves subject to the full due process.
- 1.6 This Consultation Paper only deals with the selection of measurement bases in the context of GPFs. Other measurement bases may be appropriate as supplementary disclosures or in other forms of financial reporting.

Public sector considerations

- 1.7 The Consultation Paper on the Objectives of Financial Reporting notes some of the differences between public sector not-for-profit entities and business entities. Some of these differences are relevant to the choice of measurement basis.
- 1.8 In the public sector, some assets are held for their potential for service delivery rather than for cash generation: they do not generate cash flows commensurate with their value: where there are cash flows attribution to specific assets may require subjective judgements. Many assets in the public sector are also highly specialised: they would have little utility to any entity other than the public sector entity. Because of this, it may be difficult or impossible to establish a current value for such assets and, if a market value can be established for assets that are required for service delivery, it may not be relevant. Furthermore, many assets in the public sector (for example public buildings and infrastructure assets) remain in use for decades or even centuries, and prices will often change significantly over such long periods. Although these factors also arise in the private sector, they are more pervasive in the public sector context.

Measurement at Initial Recognition and subsequent measurement

- 1.9 For most measurement models, the measurement basis used when an asset is first recognised (for example, on acquisition) is the same as that used when the asset is reported in later accounting periods.
- 1.10 Where an asset is acquired in an arm's length exchange transaction, it is frequently the case that the exchange price corresponds to that of the appropriate measurement basis, subject to consideration of transaction costs. This is the case, for example for historical cost, replacement cost and market value measurements.
- 1.11 Where the price paid for an asset (including transaction costs, where appropriate) does not correspond to the measurement basis used, a difference will arise, which is sometimes described as a 'day one' profit or loss. The treatment of this difference is not addressed in this paper.

2 The objectives of financial reporting and the qualitative characteristics: factors to be considered in choosing measurement bases

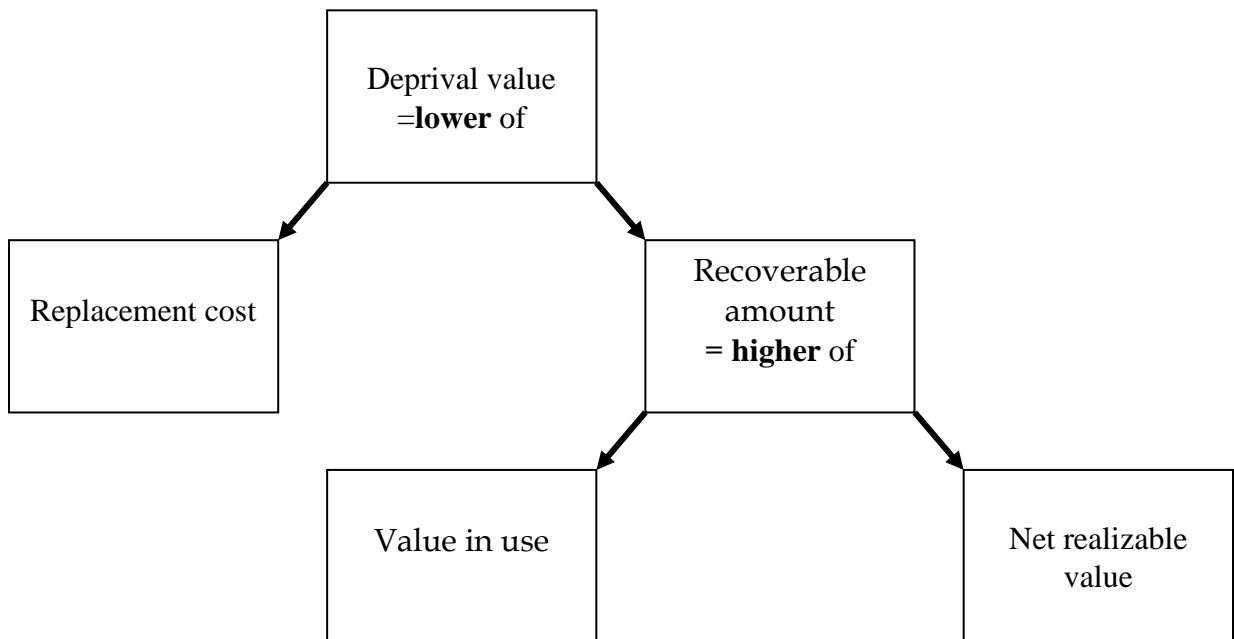
- 2.1 As is explained in CP1, the objective of financial reporting by public sector entities is to provide information about the reporting entity that is useful to users of GPFs for accountability purposes and as input for decision making purposes – (including resource allocation, political and social decisions).
- 2.2 CP1 also explains that, in order to fulfil these objectives, information should possess the qualitative characteristics of relevance, faithful representation, understandability, timeliness, comparability and verifiability. Constraints on information included in financial statement are materiality, cost and the need to achieve an appropriate balance between the qualitative characteristics.

The deprival value model

- 2.3 The deprival value model (which is sometimes referred to as the ‘value to the entity’ model), is well established in the academic literature and has been recommended for use in public sector financial reporting, for example by the Byatt Committee in the UK and the Carpenter Report in Australia. It seeks to determine the amount of the loss the entity would sustain if deprived of the asset. It does not prescribe a single measurement basis, but rather a means by which a specific measurement basis can be selected as the most relevant in specific circumstances.
- 2.4 In order for a measurement basis to be relevant for accountability and decision making purposes, it must represent a value no greater than that which the entity can derive from the asset. For example, if the entity holds inventory originally acquired for use in service delivery but that is now excessive or redundant, it will be able to derive value only from its sale. In such a circumstance it would not be relevant for either accountability or decision making purposes to measure the inventory at an amount that is greater than the service potential it represents, that is at for example, its purchase cost, but only at the lower amount that can be achieved by its sale (net realizable value).
- 2.5 However, the maximum value that can be derived from the service potential that can be provided by an asset should also be reflected if the measurement is to be relevant. A low net realizable value (such as a scrap value) would not fully reflect the value of an asset that has continuing useful service potential: the measurement basis should reflect the asset’s full service potential and any loss of value arising on a subsequent sale should be reflected when the sale is made.
- 2.6 The deprival value model suggests that a relevant measure should also not overstate the value of the service potential of an asset. For example, if prices have fallen since the asset was acquired, so that the same service potential could be obtained at a lower cost than the original cost of the asset, a carrying amount based on original cost would not provide a relevant reflection of the value of the asset. More generally, the highest value that can be attributed to an asset is the

current cost of obtaining the service potential of the asset, that is, replacement cost.

- 2.7 A relevant measure should also reflect the asset that is currently held by the entity, rather than the future contribution that the asset is expected to provide to the entity. For example, if an asset is acquired because it will enable cost savings to be achieved, those cost savings would not generally be a relevant measure of the value of the asset.
- 2.8 In summary, under the deprival value model the measurement basis reflects the loss that the entity that would sustain if deprived of the asset. This cannot be lower than the amount that would be received on sale (net realizable value) and cannot be higher than the current cost of obtaining equivalent service potential (replacement cost). The choice of measurement base reflects the highest economic value that the entity is able to derive from the asset: replacement cost is selected where the asset is worth replacing; and net realizable value when the asset is not worth replacing, and the highest value will be obtained from immediate sale. Value in use is selected by the deprival value model when an asset is not worth replacing but the value of its service potential is greater than that which would be derived from sale. This may be portrayed diagrammatically as:



- 2.9 It will be seen from the above that a relevant measure of an asset requires consideration not only of the nature of the asset itself, but also of the economic opportunities that are available to the entity to benefit from it (for example in using it to discharge its obligations to provide services) and any constraints that might limit its ability to benefit.
- 2.10 Sometimes measurement bases are rejected on the grounds that they are 'entity-specific': it is suggested that, in order to achieve comparability, an asset

should be reported at the same amount irrespective of the entity that holds it. This, however, ignores differences in the utility of an asset to different entities: as noted above, many assets held by public sector entities would have little utility to entities outside the public sector. A value that reflects the contribution of the asset to the provision of services may be more relevant than the scrap value that would be relevant if the same asset were held by another entity that had no need of its services.

- 2.11 ‘Entity-specific’ values are also sometimes opposed on the grounds that they reflect the particular intentions or expectations of the entity or its management. Valuing an asset based on the state of mind of the management of the entity would result in GPFSs that were unacceptably subjective and unverifiable. However, it is possible to distinguish management’s intentions and expectations from the economic constraints and opportunities to which a particular entity is subject. A measurement basis may be ‘entity-specific’ because it includes consideration of economic opportunities that would not be available to another party, and is bounded by the economic and existing policy constraints that limit its possible uses by the reporting entity, without reflecting simply expectations and intentions.
- 2.12 A single measurement basis within an entity’s GPFSs would be desirable, as the relationship between various amounts reported in the GPFSs would be clear: in particular the amounts of different assets and liabilities could be added to provide meaningful totals.
- 2.13 However, as is described in the remainder of this Paper, there is no single measurement basis that is appropriate in all circumstances. It is possible however, to minimize the drawbacks of using different measurement bases. This requires that different measurement bases are selected only where this is justified by economic circumstances, and hence that assets are reported on the same basis where circumstances are similar. In addition, much of the most important information conveyed by GPFSs relates to components rather than aggregate amounts, and good presentation and disclosure can ensure that the measurement bases used and the amounts reported on each basis is clear.
- 2.14 In order to meet the objectives of GPFSs, measurement bases must be selected with regard to the qualitative characteristics, especially relevance. This requires that:
 - The appropriate measurement basis is selected having regard to the economic opportunities that are available to the entity (including the use of the assets in providing services) and any constraints on its ability to benefit from the asset.
 - To be relevant, the measurement basis should reflect the maximum value that the entity can derive from the asset.
 - A relevant measurement basis must be one that is no greater than the value that the entity can derive from the asset in question.

- Because of these considerations, it follows that the measurement basis that is most appropriate in the circumstances will vary between different entities and even in the case of a single entity different measurement bases will be appropriate for different assets.

3 Historical cost

- 3.1 Under the historical cost basis assets are reported at the cost incurred on their acquisition. Historical cost is the most widely used basis of financial reporting. It has the advantages of familiarity and, because historical cost is usually recorded where assets are acquired by purchase, it is often relatively objective and simple to apply. Particularly in the context of revenues and expenses, historical cost is easily understood.
- 3.2 Compared to the available alternatives, historical cost information generally has a high degree of verifiability. Where an asset is acquired in a single transaction for cash, the historical cost is completely verifiable. Because of the simplicity of historical cost, the information can probably be prepared more quickly than that prepared using other bases, and so its use contributes to timeliness. Information prepared on a historical cost basis is also understandable, because it generally relates to actual transactions undertaken by the entity.
- 3.3 Thus financial reporting based on historical cost will in many circumstances possess to a great extent the qualitative characteristics of understandability and verifiability, and may be expected to contribute to the timeliness of financial information. The simplicity of historical cost information also has the advantage that it is the least costly method of measurement and so minimises one of the constraints on information noted in CPI.
- 3.4 These advantages, however, do not apply without qualification in all cases. It is not clear for example, that historical cost provides a useful measure in the case of assets that are acquired by donation, or on subsidised terms, or in exchange for other non-cash assets.
- 3.5 Problems also arise when assets are not purchased in a single straightforward transaction. For example:
 - Transaction costs: in addition to the purchase price of an asset, other costs may be incurred in connection with its acquisition (for example, legal fees and taxes). It is necessary to determine which costs are sufficiently directly associated with the purchase to justify their inclusion in the historical cost of the asset.
 - Assets constructed by the entity: Where an asset is constructed by the entity itself many costs (for example, labor, materials, energy) will have to be allocated. Questions arise in such cases about the calculation and treatment of borrowing costs.
 - Basket transactions: where several assets are acquired in a single transaction the price paid must be allocated to the individual assets.

- Depreciation: in the case of an asset that will be used for several accounting periods, the historical cost needs to be allocated to accounting periods. In a simple case for an asset with a relatively short useful life, and which may plausibly be said to yield equal service over its life, a simple straight-line allocation may be satisfactory, but there are many cases where a more sophisticated approach may be required.
 - Flow assumptions: where many similar assets are held, flow assumptions such as FIFO or average cost are generally employed where historical cost is used. These essentially arbitrary conventions are necessary on practical grounds, and may improve the relevance of financial information, but are a departure from a strict adherence to historical cost.
- 3.6 Although some of the issues noted here also arise under other measurement bases they are relevant to an assessment of the usefulness of historical cost, because they diminish its claimed objectivity and simplicity, and hence high degree of verifiability, understandability and low cost.
- 3.7 Records of historical cost may not always be available, especially in the case of assets that have been owned for many years and were acquired before the introduction of accruals accounting. In these cases, if historical cost is to be used as the measurement basis, an estimate of historical cost will be required, for example by reference to price indices. The subjectivity and unreliability of such estimates further detracts from the objectivity of historical cost measurement.
- 3.8 CP1 notes that users of GPFSs require information on the amount and type of resources used in the provision of services, and whether the use of resources is consistent with approved budgets. Historical cost information may be particularly suitable for comparing costs incurred against budgets because the reported amounts will be readily recognisable by the budget holder, and because budgets may not allow explicitly for changes in prices (either general or specific changes). It may be reasoned that historical cost provides the most representationally faithful measure of the cost of providing goods and services, because historical cost reflects the actual cost of the resources used.
- 3.9 However, under historical cost reporting, the cost of services provided is reported at prices prevailing at the time when the assets used in their provision were originally acquired. Thus gains and losses that are attributable to the price changes during the period in which assets are held ('holding gains and losses') are not recorded when they arise. Because information on the cost of services is reported in historical prices, it is not as relevant as current price information to the assessment of the likely future resource needs, that is, whether same service levels are likely to require increased or decreased resource levels in the future.
- 3.10 Historical cost information reflects a money capital maintenance perspective: a surplus is reported if the income for the period exceeds the historical cost of the assets consumed in providing services in the period, even if that income is less than the current cost of service provision.
- 3.11 Information prepared on an historical cost basis does not always provide relevant information on the resources held by the entity. If prices have increased since an

asset was acquired its value to the entity may be greater than that represented by historical cost. This is sometimes a particularly significant issue in the public sector where assets may remain in use for decades or even centuries.

- 3.12 Use of the historical cost basis does not secure the provision of information that is comparable. Assets that are identical (including in respect of their age and condition) may be reported at different amounts (either by two different entities or within the GPFs of a single entity) because prices prevailing at the dates of acquisition were different.

4 Replacement cost

- 4.1 The replacement cost of an asset may be defined as:

“the most economic cost required for the entity to replace the service potential of an asset at the reporting date.”

- 4.2 Because the definition refers to the cost “at the reporting date”, replacement cost, as that term is used here, is a current value, that is, it reflects economic conditions prevailing at the reporting date.

Clarification of the replacement cost concept

- 4.3 Replacement cost may be distinguished from reproduction cost: the former refers to the cost of replacing service potential, whilst the latter is the cost of obtaining an identical asset. For example, the private offices of a government department may have high ceilings and ornate plasterwork: the reproduction cost of such a building might be very high, but the replacement cost would be that of office accommodation offering the same accommodation but which might lack those features as they have no economic value. It should not, however, be assumed that use of replacement cost always entails an exhaustive search for assets with equivalent service potential: in many cases the most economic replacement cost will be that of an asset that is similar in major respects to the asset that is actually owned.
- 4.4 Because entities acquire their assets by the most economic means that is available, replacement cost reflects the usual procurement process that an entity follows. The concept of replacement cost is that of replacement in the ordinary course of operations, and not the extraordinary costs that might be incurred if an urgent necessity arose as a result of some unforeseeable event (such as a fire). Also, replacement cost reflects the particular circumstances of the entity. For example, the replacement cost of a specific kind of vehicle may be less for an entity that usually acquires large quantities of vehicles in a single transaction and thus is regularly able to negotiate discounts than it would be for an entity that purchases its vehicles individually. Where the entity is a public sector entity and its replacement cost differs from that of a private sector entity, it is the public sector price that represents replacement cost.
- 4.5 The definition of replacement cost refers to ‘service potential’, which includes both the ability to enable the entity to fulfil its service delivery objectives and to yield sales proceeds on the ultimate disposal of the asset. Because it is only

- service potential that is relevant, replacement cost is the cost of an asset that is of the same age and condition as that which is being valued. Thus where replacement cost of a used asset is ascertained by reference to the cost of a new asset, an adjustment is necessary to reflect the reduced service potential of the asset that is owned.³ Similarly an estimate of replacement cost may be reduced to reflect the cost required to repair a damaged asset.
- 4.6 The relevant service potential is that which the entity is capable of using, having regard to the need to hold capacity to enable the entity to deal with contingencies that might arise. This results in the reduction of the replacement cost of an asset when the need for its service capacity falls. For example, if a entity owns a school that is adequate for 500 pupils but, perhaps because of demographic changes since the construction of the school, a school for 100 pupils would be adequate for current and reasonably foreseeable requirements, the replacement cost of the asset is that of a school for 100 pupils.
- 4.7 Some object to the use of replacement cost on the grounds that it reflects not the cost of the asset that is owned, but rather the hypothetical cost of an asset that is not owned. They suggest that replacement cost is not appropriate as it is not an attribute of the asset that is actually owned. However, it is not the physical asset that is being valued, but rather the services that the existing asset is capable of providing.
- 4.8 The relevance of replacement cost is particularly clear where assets have to be regularly replaced, for example where a stable volume of inventory needs to be held, and so consuming inventory necessarily entails its replacement, for which the current price will have to be paid. However, replacement cost is also relevant when assets will not be replaced, as depreciation of replacement cost represents a fair charge for the cost of an asset's services that are consumed within an accounting period. Thus the relevance of replacement cost is not (as is sometimes suggested) to ensure that the GPFs report the extent to which sufficient funds for replacement are retained within the entity to provide for replacement. Rather its use enables management to use the GPFs to be accountable for the current cost of the services provided and to provide input for decision making purposes.
- 4.9 It flows from the definition of replacement cost that it includes all the costs that would necessarily be incurred in replacement of the service potential of an asset. This would include transaction costs as well as the price that would be paid for a replacement asset.

Replacement cost and the qualitative characteristics

- 4.10 The major advantage of replacement cost compared to other measurement bases is its relevance (for both accountability and decision making purposes). Unlike historical cost, replacement cost reflects economic conditions prevailing at the

³ IPSAS 21 uses the term 'replacement cost' to refer to the cost to replace the asset's gross service potential, which is depreciated to reflect the used condition of an asset. In this paper, replacement cost is defined as the cost of the remaining service potential.

- reporting date. It also reflects the economic position of the reporting entity since all (and only) the service potential that the asset affords to that entity will be reflected in its carrying amount, and does not vary according to the value—or, in the case of specialised assets, lack of value—that the asset may have to another entity. Replacement cost is consistent with the going concern assumption⁴ that the entity will continue in operation and will not reduce or terminate its activities. (Conversely, where the going concern assumption is inappropriate, replacement cost is unlikely to be relevant.)
- 4.11 Views may differ as to the understandability of information presented on a replacement cost basis, but it would be expected that with adequate explanation, it will be reasonably understandable.
- 4.12 In the case of assets that are held in order to provide services, replacement cost provides information that is relevant, because it reflects the cost of future service potential that is attributable to the asset.
- 4.13 Use of replacement cost is consistent with the use of an operating capacity concept of capital maintenance: a surplus indicates the extent to which the income for the period exceeds the current cost of the assets consumed in providing services in the period, which will need to be replaced if the same level of services are to provided in future periods.
- 4.14 It is possible to combine historical cost and replacement cost information by reporting separately the extent to which changes in prices are reflected in the costs reported in the year. These amounts are sometimes referred to as ‘realised holding gains’. This permits the GPFSs both to report the costs based on actual transactions, which may be useful for an assessment of accountability as well as the costs based on current prices which is useful to an assessment of future resource needs. The quantification of realised holding gains requires a flow assumption to be used, because it requires quantification of the historical cost of assets consumed: as noted above, flow assumptions are inevitably arbitrary.
- 4.15 In case of fixed assets, it is important to distinguish changes that are the cost of the consumption of service potential (i.e. depreciation) from changes that are the result of changing prices.
- 4.16 It is apparent that in some cases calculation of replacement cost will be complex and subjective judgements will be required. This will prejudice the timeliness, comparability and verifiability of information prepared on a replacement cost basis, and will also make it more costly than some alternatives. However, calculations of replacement cost need not be carried out more frequently than is necessary to ensure that the GPFSs are not materially misstated as a result of the failure to obtain an up-to-date replacement cost. The period between valuations should also be chosen to ensure that the cost is commensurate with the benefit of improved financial information.

⁴ [Cross reference to discussion of going concern elsewhere in the Framework to be considered.]

Alternative use assets

- 4.17 Replacement cost (as defined above) reflects the cost of the service potential that the entity is able to use. A consequence of this is that replacement cost may understate the value of an asset if it has alternative uses that could be exploited by others. For example, if a government department is located in a building in a prime central business district but could function equally well at a less valuable remote location then replacement cost is the cost of a building in that remote location. Arguably, replacement cost would, in such a case, not provide a relevant measure of the value of the asset that is used in the entity's operations, because the entity could sell the present asset and obtain equivalent service potential at current replacement cost
- 4.18 Where it appears that there may be incremental value arising from an alternative use it is necessary to consider whether the existing use of the asset requires the current location. If it is necessary for an activity to be carried out in a prime business location, then the full value of that asset relates to that activity, and not to an alternative use. This is the case even if the market value of the asset is very high and the current activity (for example, providing public services) yields little or no cash flow. Thus incremental value relating to an alternative use may arise comparatively rarely.
- 4.19 The strength of the evidence that the value represented by the alternative use would actually be received in the event of sale. Possible sales for alternative uses will range from the probable to the speculative, or even fanciful. It would not be appropriate for an alternative use value to be reflected in the financial statements unless there was adequate evidence that it was representationally faithful of the value of the asset to the entity. The value that might be obtained from an alternative use would also be reduced by the costs of relocation and disruption to activities that would be caused by a move to alternative premises.
- 4.20 This suggests that incremental value relating to an alternative use should only be reflected where there is a high degree of evidence to support it, for example where the entity is planning disposal of the asset and has received professional advice in that connection.
- 4.21 In other cases, apparent incremental value due to a possible alternative use may be best dealt with by supplementary disclosure either in the notes to the GPFSs or elsewhere in GPFRs.

5 Market value

- 5.1 This section discusses the use of market value as a measurement basis. For this purpose, 'market value' is used here to mean the price prevailing on an active market for homogeneous assets where there are many buyers and sellers, prices are publically available and no difference between buying and selling prices.⁵

⁵ The term 'market value' may be defined differently for different purposes. For example, the International Valuation Standards Committee defines market value as 'The estimated amount for

Although in practice such markets do not exist, there are some that approach that ideal and may provide prices that are useful for financial reporting.

5.2 It can be reasoned that market value is a measurement basis that possesses all of the qualitative characteristics of financial information, as is discussed below.

- Relevance: the discussion in section 2 above suggests that a measure that is relevant for assessing accountability and decision-making can be no greater than the value that the entity can derive from the asset: the existence of a market to which the entity has access ensures that the entity can derive at least market value. Section 2 also suggests that assets should be stated at the maximum value that the entity can derive from the asset, but that this cannot be greater than the cost of replacing the asset's service potential: the existence of a market ensures that the service potential can be replaced at the market value.
- Faithful representation: market values provide a faithful representation of the value of the asset;
- Understandability: market values are easy to understand;
- Timeliness: where market values are readily available, the GPFSs can be prepared quickly and with only simple calculations;
- Comparability: different entities owning similar assets should report them at the same market value, so the information is highly comparable;
- Verifiability: if market values are readily available the information can be easily verified.

5.3 The relevance of market values is sometimes questioned where assets are held for the long-term. In such a case it might be argued that the short-term changes in value that are reported where a market value basis is used are not relevant to the entity's financial position and performance. An example is an equity investment that is held to finance pension obligations: it might be suggested that it is primarily held with a view to the receipt of dividends and long-term capital appreciation, and that a fall (or indeed a rise) in market values is of no relevance if expectations of future returns are unchanged.

5.4 However, provided the entity is able to purchase a similar investment at the market price, that price represents the advantage attributable to the asset. The entity could secure the same prospective future dividend receipts at the market price, so it would not be representationally faithful to report the value of the asset at a higher amount. Another way of making the point is to observe that the value of an equity investment is the same to all market participants since it offers all of them the potential of future dividends and capital appreciation. Thus, where an

which a property should exchange on the date of valuation between a willing buyer and a willing seller in an arm's length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently, and without compulsion. (Concepts Fundamental to Generally Accepted Accounting Principles (GAVP), paragraph 5.2) *[Reference to be verified/updated.]*

asset is widely traded on a market its value will be the same to all holders who have access to that market, and the objection that market values are not relevant to long-term holdings cannot be sustained.

- 5.5 However, if there is no active market for an asset, or if the needs and possible uses of the asset differ for different entities, the asset may be worth more to the reporting entity than its market value. This may arise for assets that are held for their service potential in order to fulfil public sector objectives: it may be that any potential purchaser would pay only a reduced amount reflecting the cost of adapting the asset for an alternative use. In these cases, the extent to which market value provides relevant and representationally faithful information may be questioned.
- 5.6 A prison, for example, might be constructed at a cost that is much higher than the price that would be paid by a private sector entity that would have to adapt it for a private sector use. Reporting that asset at a low market value would not be relevant, as the entity is unlikely to dispose of an asset that it requires in order to fulfil its service objectives. Nor would a low market value be representationally faithful of the value of the asset to the public sector entity, who can obtain the services provided by the asset only by incurring a cost that is greater than that market value. Nor would the reported decrease in value from cost to market value faithfully represent the financial performance of the entity.
- 5.7 This discussion reflects the view that the measurement basis used for financial reporting purposes may properly reflect economic opportunities that are available only to the reporting entity, and would not be available to another party. Part of the argument is that there are no such opportunities for the equity investment discussed in paragraphs 5.3 and 5.4 above, but there are for the prison discussed in paragraphs 5.5 and 5.6. Some would disagree. They would contend that an entity should report an asset at market value because this should result in the same asset being reported at similar amounts by different entities. On this view the benefit of superior economic opportunities that are available to the reporting entity are reflected in financial reporting at the time that the entity exploits and benefits from those opportunities. However, this approach may fail in a public sector context (as in the prison example) to reflect the full value of the asset simply because other entities could not utilise it in the same way as the public sector entity.
- 5.8 In some cases active markets for identical assets (as described in paragraph 5.1 above) do not exist, but prices may be estimated, for example from prices quoted for similar assets, or by inference from data that reflect the inputs (interest rates, currency exchange rates etc.) that would be used if the asset were to be purchased or sold. For example, an unquoted equity investment might be valued by reference to prices for similar quoted investments, adjusted to reflect the lower liquidity associated with an unquoted investment. This would have the advantage of promoting consistency with the valuation of other similar assets, and this may outweigh the disadvantages of the complexity and subjectivity which will impair comparability and verifiability. Estimated market values may not always be understandable, because there is a risk that the user will conclude that assets can

always be readily realised at the market value at which they are stated. Where estimates are made by use of mathematical models, there is a risk that the limitations of such models and the assumptions on which they rely is not understood.

- 5.9 In this discussion it has been assumed that there are no differences between entry (buying) prices and exit (selling) prices, and that there are no transaction costs. These factors may need to be addressed if prices derived from market values are to be used for financial reporting purposes. If an entry perspective is relevant, buying prices and transaction costs would be included, and would be consistent with the use of replacement cost. If an exit perspective is relevant, selling prices and the costs of making the sale would be deducted.

6 Impairment of Assets and Recoverable Amount

- 6.1 In all the measurement bases an asset cannot be stated at an amount greater than the value of the future economic benefits that it is capable of providing to the reporting entity: this is referred to in this paper as the asset's 'recoverable amount'⁶. Where the carrying amount exceeds recoverable amount, the asset is impaired and a reduction in its carrying amount has to be made.
- 6.2 As a practical matter, an asset's recoverable amount is only explicitly considered where events or circumstances suggest that an impairment is possible. Furthermore, as noted, in paragraph 4.6 above, where assets are stated at replacement cost, a reduction in the service capacity that an entity can use is reflected by a reduction in current replacement cost. Where such a reduction is made, explicit consideration of recoverable amount may be unnecessary.
- 6.3 The recoverable amount of an asset is the higher of:
- Value in use: the present value to the entity of the asset's remaining service potential if it continues to be used, and the amount that the entity will receive from its disposal at the end of its useful life and;
 - Net selling price: the amount that the entity can obtain from sale of the asset at the reporting date.
- 6.4 The higher of these two values is the recoverable amount irrespective of whether the entity intends to continue to use or sell the asset: if an entity chooses to deploy an asset in a way that does not recover the maximum amount, the consequence of that decision is reflected in the periods in which it is implemented and not anticipated by stating the asset at an amount that is lower than the amount that can be recovered.
- 6.5 In some cases an asset's value in use can be quantified by calculating the present value of the future cash flows that the entity will derive from the asset (or the cash outflows that holding the asset will avoid), assuming its continued use. This

⁶ IPSAS 21 'Impairment of non-cash generating assets' uses the term 'recoverable service potential'.

should take account of the risk of variations in the amount and timing of cash flows, and the time value of money.

- 6.6 In practice, the calculation of value in use is often difficult. Assets that are employed in cash generating activities often provide cash flows jointly with other assets, and so value in use can be estimated only by calculating the present value of the cash flows of a group of assets and allocating the total (inevitably with some arbitrariness) to individual assets. In the public sector, many assets contribute to the provision of services rather than directly generating cash flows: such assets are referred to as ‘non-cash generating assets’.
- 6.7 The recoverable amount of an asset cannot be lower than net selling price. In estimating that amount it is necessary to take account of the costs that would be incurred on the disposal of the asset, including legal costs, taxes and commissions that relate directly to the sale and the costs of bringing the asset into a location and condition suitable for sale.

7 Concluding comments

- 7.1 No single basis of measurement is likely to be appropriate in all cases: judgement will be required in setting and applying accounting standards to select the measurement basis that is most appropriate to the circumstances of the case, which will be that which strikes the most appropriate balance between the qualitative characteristics. The most important judgement will often be to secure the maximum degree of relevance that can be obtained at reasonable cost and with an adequate degree of verifiability.
- 7.2 Although historical cost has many advantages, the greater relevance of current measures may suggest their use in some cases. In particular, it may be thought that price changes are a major issue mainly for fixed assets, and that current measures will not provide a significant improvement over historical cost for current assets, as they are typically consumed within a short period of their acquisition (especially where inventory is of specialised assets, rather than commodities). But although the impact of general inflation in a short period may be small, specific price changes may nonetheless be significant.
- 7.3 Market value is the most straightforward current measure, where assets are traded on active markets. It may therefore be particularly suitable for assets such as commodities and some financial instruments. However, operational assets are diverse and specialised: the economic constraints and opportunities differ significantly for different market participants.
- 7.4 Replacement cost often provides a relevant current measure for operational assets and may be used where it is not unduly costly. Care needs to be taken in the application of replacement cost to ensure that assets are not stated above their recoverable amount, and that assets with alternative uses are treated appropriately.
- 7.5 The case for market value and replacement cost rather than historical cost is strengthened by their use in the statistical basis of accounting.

Appendix A

IASB projects on measurement

- A1 The IASB has two current projects that relate to measurement, its project on a Conceptual Framework and its Exposure Draft 'Fair Value Measurement'. IPSASB will continue to monitor this work in developing its own conceptual framework.

Conceptual Framework project

- A2 IASB's project on the Conceptual Framework is undertaken jointly by the IASB and the US Financial Accounting Standards Board. Phase C of that project is on the subject of measurement. No proposals relating to that phase have been published at the time of publication of this Consultation Paper.

Fair value Measurement

- A3 The IASB published an Exposure Draft 'Fair Value Measurement' in May 2009. The Exposure Draft is based on Statement of Financial Accounting Standards No 157 (FAS 157), issued by the Financial Accounting Standards Board of the United States.

- A.4 The Exposure Draft is not intended as a contribution to the conceptual framework, but proposes guidance for the application of 'fair value' in those circumstances where that is the measurement basis required by other accounting standards.

- A.5 'Fair value' as set out in the Exposure Draft is intended to be a market value, where adequate market evidence exists. It therefore addresses many of the issues that arise in the implementation of a market value measurement basis. It addresses the use of fair value in cases where assets are not traded on an active market. Where market evidence is lacking, the Exposure Draft proposes alternative approaches, but the objective—an exit price from the perspective of a market participant—remains the same.

- A.6 The Exposure Draft defines fair value as:

'Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.'

The Exposure Draft therefore defines fair value as an exit value amount.

- A.7 The Exposure Draft suggests that, for assets that do not have observable market values and do not generate cash flows, replacement cost may form an acceptable basis of measuring fair value. In such cases, consistent with the market participant objective, replacement cost should reflect the assumptions that a market participant, rather than the entity, would use. The market participant is deemed to have, or the ability to obtain, any complementary assets necessary for use of the assets in its own operations.

- A.8 The IPSASB has concluded that in the public-sector context an exit value perspective is not generally appropriate for operational assets with remaining service potential. Because the IASB Exposure Draft permits the use of replacement cost in some contexts, the resulting values may sometimes be similar to those that would arise from application of the principles set out in this Consultation Paper (although there remains the possibility of a difference between the cost that the reporting entity would incur to replace an asset and that which another market participant would incur). . However, the recourse to a market participant that has the same opportunities as the reporting entity seems to be excessively hypothetical in the public sector context. It is also clearer to establish an entry value (replacement cost) objective, rather than to reason that in some circumstances a replacement cost valuation can represent an exit value.

LIABILITIES IN THE CONTEXT OF THE DEPRIVAL VALUE MODEL

The following sets out an application of the deprival value model to liabilities. It is intended to establish general principles that should be relevant to all liabilities: financial and non-financial; those that arise from exchange and non-exchange transactions.

- 1 Many of the considerations that arise in connection with the selection of a measurement basis for liabilities are parallel to those that arise in the context of assets. As with assets, measurement of liabilities requires selection of an appropriate measurement basis.
- 2 Application of the deprival value model requires consideration of the following measurement bases include:
 - (i) the price at which the entity would rationally be willing to assume the liability (assumption price)
 - (ii) the cost of fulfilling the obligations represented by the liability (cost of fulfilment). Where the obligation is financial, fulfilment will be making the required payments; where the obligation is to provide goods or services, fulfilment consists of providing those goods or services.,
 - (iii) the cost at which release from the liability could be obtained (cost of release). Release may be obtained either by obtaining the consent of the party to whom the obligation is owed or, by transferring the liability to a third party.
- 3 The discussion of assets in the draft Consultation Paper notes that a relevant measurement basis for assets:
 - (i) cannot be lower than the maximum value that the entity can derive from the asset, but
 - (ii) cannot be greater than current replacement cost.

Because in many cases replacement cost will be lower than the maximum value that the entity can derive from the asset, it will be the appropriate basis.

For liabilities, the parallel principles are that a relevant measurement basis:

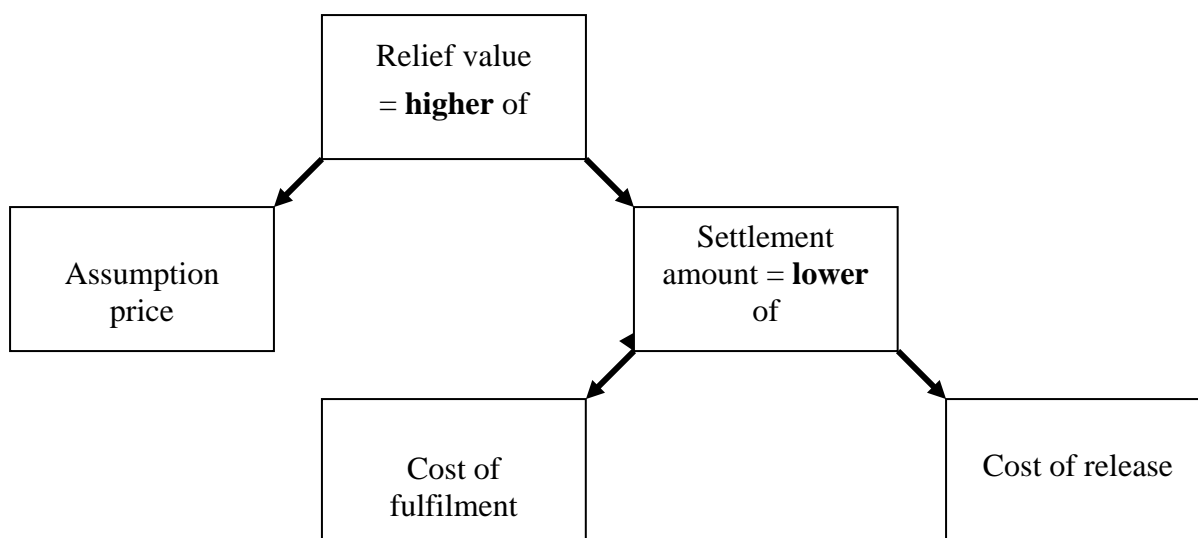
- (i) cannot be lower than the minimum burden that the liability represents to the entity, but
- (ii) cannot be greater than the price at which the entity would rationally assume the liability, which is assumption price.

Because in many cases assumption price is higher than the minimum burden represented by the liability, it will be the appropriate basis.

- 4 The concepts applicable to assets and liabilities may be arranged in parallel as follows:

	Assets	Liabilities
General concept	<p>Deprivation value:</p> <p>What amount would just compensate the entity for the loss of the asset at the reporting date?</p> <p><u>or, equivalently,</u> What loss would the entity sustain if deprived of the asset?</p> <p><u>or, equivalently,</u> How much would the entity rationally pay to acquire the asset (if it did not already hold it)?</p>	<p>Relief value:</p> <p>What amount would the entity rationally pay to settle the liability at the reporting date?</p> <p><u>or, equivalently,</u> What gain would the entity enjoy if were relieved of the liability?</p> <p><u>or, equivalently,</u> What amount would the entity rationally accept to assume the liability (if it did not already have it)?</p>
Entry or exit?	Lower of entry and exit	Higher of entry and exit
Entry value	Replacement cost	Assumption price
Exit value	Recoverable amount — higher of:	Settlement amount — lower of:
	Value in use	Cost of fulfilment
	Net realizable value	Cost of release

- 5 The relationship between the measurement bases for liabilities can be shown diagrammatically as follows:



Settlement amount

- 6 If a liability may be extinguished either by fulfilling at a cost of CU600, or by securing release at a cost of CU800, the cost of fulfilment is a more relevant

measurement basis than the cost of release. Conversely, where seeking release is less costly than fulfilment (and assuming that seeking release is a feasible course of action for the entity) then cost of release is a more relevant measure than cost of fulfilment.

Cost of fulfilment

- 7 The cost of fulfilment includes all costs that the entity will incur in fulfilling the obligations represented by the liability, assuming that it does so in the least costly manner. The costs include not only payments to the counterparty but also other costs that will arise from fulfilling the obligation.
- 8 Where the cost of fulfilment depends on uncertain future events, , all possible outcomes are reflected in the estimated cost of fulfilment.
- 9 Where fulfilment requires work to be done—for example where the liability is to make good environmental damage—the relevant costs are those that the entity will incur: this may be the cost of doing the work itself, or of employing a contractor to do the work on behalf of the entity. However, the costs of employing a contractor are only relevant where employing a contractor is the least costly means of fulfilling the obligation.
- 10 The cost of fulfilling a liability is the value to the entity of resources that will be used in making fulfilment, and not necessarily their carrying amount.
- 11 Where fulfilment will be made by the entity itself, the fulfilment cost does not include any profit, as any such profit does not represent a use of the entity's resources. Where fulfilment amount is based on the charges of employing a contractor, the amount will implicitly include the profit required by the contractor: however the total amount charged by the contractor will be a demand on the entity's resources.
- 12 Where fulfilment will not take place for an extended period, the costs need to be discounted to reflect the value of the liability at the reporting date. Conceptually, the discount rate is reduced to reflect the riskiness of the liability—the higher the risk, the lower the discount rate and hence the larger the liability at the reporting date. However, in practice it is often impracticable to quantify the appropriate adjustment for risk. Where this is the case a risk-free rate may be used.
- 13 Financial statements are drawn up on the assumption of the entity's continued existence, that is, the going concern assumption. It is inconsistent with that assumption to reflect the possibility that the entity may default on a liability. Accordingly, the fulfilment amount should not be reduced to reflect the entity's own credit risk either on the initial recognition of a liability or when the liability is subsequently remeasured.

Cost of release

- 14 Cost of release refers to the amount that either (i) the creditor will accept in settlement of its claim; and (ii) a third party would charge to accept the transfer of

- the liability. Where there is more than one means of securing release from the liability, the cost of release is the lowest amount.
- 15 Transferring a liability may be distinguished from entering into an agreement with another party that who will fulfil the entity's obligation or bear all the costs stemming from a liability. In order for a liability to be transferred it is necessary that all of the creditor's rights against the entity are extinguished. If the entity's liability is not discharged, it should continue to report it but may have a separate asset representing its rights against the other party. For example, if an entity has an obligation under a lease to restore a property and pays a contractor to carry out the necessary work, payment gives rise to a right against the contractor, not transfer of the liability (unless the lessor is a party to the arrangement).
 - 16 For many liabilities it will be clear that transfer is not possible (or practicable) and cost of release will therefore be simply the amount that the creditor will accept in settlement of its claim. This will be known if it is specified in the agreement with the creditor (for example, where a contract includes a cancellation clause). In some cases there may be evidence of the price at which liabilities may be transferred (for example in the case of some pension liabilities). In other cases cost of release will not be known, but adequate evidence may exist to show that it must be higher than cost of fulfilment (and therefore the settlement amount is cost of fulfilment).
 - 17 Cost of release will usually be more than the cost of fulfilment. A creditor will usually attach a higher value to fulfilment than release and will therefore require a premium to accept immediate settlement. A third party will usually incur the same costs in fulfilling an obligation as the reporting entity and will only accept a transfer at a lower price if it has a competitive advantage. Thus the cases in which cost of release is the appropriate measurement basis may be expected to be relatively rare, but this may be the case, for example, where a contract has become onerous.
 - 18 In considering whether cost of release is appropriate it is necessary to consider whether release in the envisaged manner is an option that is open to the entity in practice, including any consequences of obtaining release, such as damage to the entity's reputation.

Assumption price

- 19 In the context of an activity that is carried out with a view to profit, an entity will assume a liability only if the price it receives is greater than the cost of fulfilment or release (i.e. settlement amount). Once that amount has been paid, the entity has a performance obligation, and is accountable to its creditor for the amount that has been paid.
- 20 In these circumstances, reporting the liability at settlement amount would not be representationally faithful: although the entity expects to be able to settle the liability in the future at the settlement amount, it remains accountable for the price

- paid, and that, rather than settlement amount, represents the obligation at the reporting date.
- 21 A consequence of stating performance obligations at the assumption price is that no profit is reported at the time the obligation is taken on. Profit is reported in the financial statements in the period of fulfilment (or release), as it is the difference between the revenue arising in respect of satisfaction of the liability and the cost of settlement.
- 22 It is sometimes questioned whether items reported as ‘deferred revenue’ are liabilities as defined in the conceptual framework. However, many such items can be seen as performance obligations that are measured at assumption price.
- 23 An entity may have a potential obligation to its customer that is larger than assumption price. If the entity seeks release from a contract, the customer may be able to claim recompense for losses that it will sustain, as well as the return of any amounts paid. However, provided that the entity can settle the obligation by fulfilment, it can avoid such additional obligations and it is representationally faithful to report the obligation at assumption price.
- 24 Just as replacement cost is a current value so, conceptually, is assumption price. There are, however, serious practical and conceptual problems in reflecting changes in prices in obligations that are stated at assumption price.

Onerous contracts

- 25 It was noted above that, when an obligation is assumed in the context of an activity that is carried out with a view to profit, the assumption price will typically be greater than the expected settlement amount. This may change at a later time, when it becomes clear that settlement will now be more costly, and exceeds the original assumption price. In this circumstance, the assumption price no longer provides a representationally faithful representation of the liability. The relief model requires that in this case the obligation is measured at settlement amount.
- 26 Because, as mentioned above, the settlement amount does not include an element for profit, no profit will be made when an onerous contract is settled.

Non-exchange transactions

- 27 In the context of non-exchange transactions, assumption price will be hypothetical and of doubtful irrelevant. In this case, the relief model suggests that the appropriate measurement basis for the liability is settlement amount.

CONCEPTS OF CAPITAL

- 1 The capital of an entity is a concept of its wealth. The surplus or deficit of an entity in a period represents the difference between its capital at the beginning and end of a period. The significance of that surplus or deficit depends on the concept of capital. A change in net assets will be reflected in surplus or deficit to the extent that it represents a change in that capital.
- 2 Financial statements may reflect a concept of capital in a number of ways:
 - The measurement basis for assets and liabilities can be chosen to be appropriate for the concept of capital that is employed. This has the advantage that the articulation of the financial statements is complete: the change in reported net assets equals the reported surplus or deficit for the year (subject to transactions with owners, in their capacity as owners).
 - Particular changes in reported net assets can be excluded from the surplus or deficit (and reported, for example, in other comprehensive income) on the grounds that they do not, under the chosen concept of capital, represent part of the surplus or deficit of the period.¹
 - Capital maintenance adjustments may be made in arriving at the surplus or deficit for the year. The cumulative amount of such adjustments is then reported as a component of equity, separate from accumulated surplus or deficit.
- 3 Concepts of capital may be broadly described as being of two types: financial and physical concepts. Within each of these there are number of concepts and some issues of definition.
- 4 Financial concepts of capital employ a money perspective. The concept may be nominal, that is, the number of units of currency held. Alternatively, a ‘real terms’ financial capital concept can be used, under which capital is defined in terms of constant purchasing power: to reflect this capital is adjusted by changes in a price index. A real terms financial concept is sometimes referred to as a proprietary concept, reflecting the fact that (in the private sector) shareholders are interested in maintaining the purchasing power of their investment.
- 5 If a real terms concept of capital is used it is preferable to do so by means of specific capital adjustments rather than by restating the carrying amounts of assets by reference to a general index. This is because the price of the specific assets held by the entity may not have changed in accordance with the general index. If the assets are revalued to current prices, and gains and losses are then adjusted by reference to general price changes, the financial statements will show the extent to which gains and losses are ‘real’.

¹ In practice, it is often difficult to discern whether some items of income and expense are reported in other comprehensive income rather than in surplus or deficit because of concerns with the concept of capital or for other reasons.

- 6 A physical concept of capital emphasises an entity's need to maintain its operating capacity. This concept is sometimes referred to as 'the entity concept'.
- 7 Operating capacity may be assessed either in terms of the volume or the value of the output of an entity's assets: in the past a volume concept has attracted most support. Another issue that arises is the extent to which financial assets and liabilities are to be included in the concept of 'operating capacity'.
- 8 An operating capacity concept is appropriate where an entity is engaged in the provision of services, and whose operating capacity is therefore easy to define. Use of this concept will assist in meeting the needs of users who wish to assess the extent to which the entity has maintained its ability to provide services in the future. (It should be noted, however, that even if operating capacity is maintained, the entity may not have sufficient resources to meet the future demand for its services.)
- 9 Where an operating capacity concept is used, articulation of the financial statements is assisted if a current replacement cost measurement basis is used, because the operating result reflects the current cost of assets consumed in operations. However, not all changes in replacement cost are reported in arriving at the operating result on an operating capacity basis, as holding gains and losses are reported separately.
- 10 A financial concept of capital maintenance is appropriate for the reporting of certain types of activity where operating capacity is difficult to define or of doubtful relevance. One example is an entity that is engaged in a specific activity of limited duration (such as managing a sporting or cultural festival). Another is an entity that is engaged in activities that essentially consist of managing a store of value, such as a fund of financial instruments. One possibility in the latter case is to use a concept of capital based on the ability to earn a market rate of return: this can be implemented by stating assets and liabilities at market values, if it is assumed that such values reflect the market rate of return.
- 11 It is, however not necessary to choose a single concept of capital. For example, an entity might segment its activities. It could use an operating capacity concept to report the results of its operating activities reported, and a financial capacity concept to report the results of other activities. It is also possible to report an operating result, based on an operating capacity capital maintenance concept, and, after the addition of holding gains, make an adjustment to show the result after maintaining real financial capital.
- 12 The following table summarises measurement bases, associated capital concepts and the adjustments to changes in reported assets and liabilities that would be required.

Measurement basis	Concept of Capital	Reporting changes in assets and liabilities
Historical cost	Nominal financial capital	All changes reported in surplus or deficit.
Any	Real terms financial capital	Capital maintenance adjustment applied, based on a price index.
Replacement cost	Operating capacity	Current cost of consumption and holding gains/losses reported separately.
Market value	Ability to earn a market return	All changes reported in surplus or deficit. Effects of changes in prices may be distinguished.

- 13 Ultimately the choice of capital concept(s) to be used must depend on the needs of users. Where there are a variety of users with different needs, more than one concept of capital may be used either in a single set of financial statements or more than one set of financial statements may be prepared.