



INTERNATIONAL FEDERATION
OF ACCOUNTANTS

545 Fifth Avenue, 14th Floor Tel: (212) 286-9344
New York, New York 10017 Fax: (212) 286-9570
Internet: <http://www.ifac.org>

Agenda Item
3D

Date: November 22, 2011
Memo to: Members of the IPSASB
From: Andrew Lennard
Subject: Conceptual Framework Phase 3 Consultation Paper: *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: Measurement of Assets and Liabilities in Financial Statements*

Objective of this Session

1. The objective of this session is to **consider** certain issues relating to Phase 3: Measurement of the Conceptual Framework project and to **confirm** Staff views or provide alternative directions.

Action Required

2. The IPSASB is asked to:
 - **Consider** whether staff recommendations for a measurement objective are appropriate;
 - **Identify** further issues on which future discussion should be focused; and
 - **Consider** a draft outline of an Exposure Draft (CF-ED3) and **provide** directions for the development of an Exposure Draft.

Agenda Material

3. Agenda material attached to this memorandum:
 - 3D.1 Issues Paper, *A Measurement Objective*;
 - 3D.2 Issues Paper, *A Possible Outline of an Exposure Draft*; and
 - 3D.3 Extract of the draft minutes of the September meeting.Other relevant materials previously distributed for the September 2011 IPSASB meeting:
 - A copy of the Phase 3 Consultation Paper (CF-CP3), *Measurement of Assets and Liabilities in Financial Statements*;
 - A copy of all submissions received;
 - Overview of responses by geographic location, function and language; and

- Staff summary and collation of responses received.

Background

4. At the September meeting in Toronto, the IPSASB received a staff summary and collation of responses to CF–CP3, and discussed some of the major issues arising. The papers for this meeting build on that discussion, with a view to the preparation of a draft of CF–ED3.

Issues not Dealt with in These Papers

5. There are two issues that are not discussed in these papers (although the draft Outline indicates a possible placement for discussion of them in CF–ED3)
 - Concepts of capital and capital maintenance. There seemed only limited enthusiasm for a significant discussion of these at the September meeting. The treatment to be accorded to this subject depends on the measurement objective that is adopted. (Note that Agenda Paper 3C.1 contains a discussion of concepts of capital and capital maintenance in the context of elements.)
 - Liabilities. The draft outline suggests that, similarly to the approach adopted in CF–CP3, the arguments in CF–ED3 should initially focus on assets, and that a later section should revisit the arguments from the perspective of liabilities. Staff are of the view that the principles that should apply to liabilities are the same as those that should apply to assets, with some changes of terminology and emphasis. This approach is reflected in the Draft Outline, although this section will probably need to be expanded.
6. It is not intended to discuss at this meeting the issue of reflecting an entity's own credit risk in liabilities (the subject of SMC 4 in CF–CP3) or of assets that may be sold for an alternative use (the subject of SMC 5). Staff are of the view that these are probably best dealt with at the standards level, rather than the conceptual level. However, if it proves necessary or desirable to deal with them in the Framework, proposals (taking account of the comments received from respondents on these issues) will be brought to a future meeting.

Next Steps

7. Staff intends to bring a first draft of an CF–ED3 to the March 2012 meeting.

Issues Paper

Conceptual Framework, Phase 3: A Measurement Objective

Introduction

1. At the September meeting, the IPSASB reviewed the responses to the Consultation Paper, *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: Measurement of Assets and Liabilities in Financial Statements* (hereafter, “CF–CP3”). It was noted that many respondents supported the proposal that the Conceptual Framework should seek to identify factors that are relevant to the selection of a measurement basis. This contrasted with an aspiration to prescribe a single measurement objective, or a rigid hierarchy that should be used in all cases. However, there was also support for the idea that the selection of a measurement basis should be guided by an overall measurement objective. The Board agreed that this should be explored further. This memorandum discusses what that overall objective should be.
2. Many of the arguments in this memorandum repeat points that have been made in earlier papers in the project, and in CF–CP3. Judgement has been necessary to focus on those points that are critical to the determination of the measurement objective, and to keep the discussion as concise as reasonably practicable.

Objectives and Qualitative Characteristics

3. CF–ED1 states “The objectives of financial reporting by public sector entities are to provide information about the entity that is useful to users of GPFRs for accountability purposes and for decision-making purposes” (paragraph 2.1). It goes on to discuss that this requires information about the financial position, financial performance and changes in net assets of the entity, and emphasizes the importance of information about the costs of service delivery (paragraph 2.16).
4. CF–ED1 also identifies the qualitative characteristics of information included in GPFRs of public sector entities as: relevance; faithful representation (which includes reliability); understandability; timeliness; comparability; and verifiability (paragraph 3.2). It notes the pervasive constraints on information included in GPFRs of materiality, cost-benefit, and achieving an appropriate balance between the qualitative characteristics (paragraph 3.3).
5. It is obviously important that the measurement objective should maximize the extent to which it can be expected to lead to financial statements that fulfill the objectives of financial reporting and the qualitative characteristics. It should, however, be recognized that judgments on the qualitative characteristics and constraints vary depending on the circumstances. In the CF judgments must be made at a high level of generality, and it is easier to make general judgments about some characteristics than others. For example, it may be comparatively easy to agree that some information will generally be relevant: whether it can be produced on a timely basis, or meet a reasonable test of cost-benefit is

likely to vary according to specific circumstances. An overarching measurement objective is obviously at the highest level of generality. A table may help (Table 1):

Table 1: Hierarchy of Measurement

1	Overarching Measurement objective	Discussed in the CF
2	Specific Measurement bases	Discussed in the CF and related to overarching objective
3	Selection of measurement bases for specific classes of transactions	Specified in accounting standards, using the guidance in the CF
4	Selection of measurement bases in a specific case	Determined by the preparer having regard to accounting standards (or CF if no standard)

6. The measurement objective will not usually alone provide sufficient guidance to ensure that similar measurement bases are consistently selected. That role is fulfilled by accounting standards, the development of which (it is envisaged) is assisted by the discussion of specific measurement bases set out in the Framework. In the preparation of financial statements the preparer has to comply with accounting standards: however a measurement basis other than that identified in the standard might be used, for example because it is less costly and it is reasonable to assume that the difference from the identified basis is not material.
7. CF–CP3 identified three “Features of Measurement Bases”:
 - Current or historical;
 - Market or entity-specific; and
 - Entry or exit.
8. The following sections of this paper discuss how each of these features should be reflected in the measurement objective.

Current or Historical Values?

9. There are several current measurement bases (such as fair value, value in use and replacement cost) but historical cost is the only historical measurement basis that is widely used in financial reporting.

10. The decision as to whether the measurement objective should represent a current value or an historical one is critical. If it is to represent a current value, it then needs to be decided which current value(s) should be selected. If the objective is to include historical information, it then needs to be determined whether there are circumstances when an alternative measurement objective to historical cost should be used. This is addressed at paragraphs 52–59 below.
11. It was noted in September that it is highly likely that standards are likely to permit or require the use of historical cost in many circumstances because of its simplicity, reliability, and low cost relative to other bases of measurement. Clearly this would be consistent with the Framework if the overall objective were to include historical cost. Alternatively, the Framework might specify a current measurement objective, and discuss why, in many common circumstances, historical cost may be used as a proxy for the conceptual ideal. In other words, if the measurement objective does not explicitly refer to historical cost, historical cost may be introduced in the Framework at level 2 of the table in paragraph 5 above.
12. A measurement basis plays a dual role: in the statement of financial position it portrays the value of the asset, and when the asset is consumed it determines the amount of the cost reported in the statement of financial performance.

Statement of Financial Position

13. Where assets are valued at historical cost, the amount in the statement of financial position is based on the amount originally paid to acquire the asset, (adjustments for depreciation or amortisation are part of the application of, rather than a departure from, historical cost). Where a current measurement basis is used, the amount reflects the economic environment prevailing at the reporting date. (Which particular aspect of the economic environment is reflected will vary depending on the specific current measurement basis that is used.)
14. It may be argued that current value measurement bases provide greater comparability between entities. If two entities own identical assets and are in a similar economic position, then they may be expected to have similar current values. However, if the entities acquired the assets at times when different prices prevailed, then their historical costs will differ. On the other hand, two entities that report assets at the same historical cost may have different underlying assets if they were acquired at different times. CF–CP3 noted that the failure to reflect price changes affected relevance as well as comparability and was a significant issue for the public sector where assets may remain in use for decades or even centuries, and so might obscure the existence of hidden reserves.
15. If the purpose of the statement of financial position is to show the financial position at the reporting date, then current values seem be more relevant and representationally faithful. If, on the other hand, the purpose is to show the amount of assets that have been acquired to provide future services, and the most faithful representation of the cost of the future services, which will involve consumption of those assets, is that reported under historical

cost, then historical cost is to be preferred. Some would consider that the relevance of historical cost in this context is limited to those who wish to assess likely future reported results, rather than future economic events.

Statement of Financial Performance

16. The view that historical cost represents the true cost of the consumption of an asset is widely held. Several respondents to CF–CP3 expressed this view, and it is also found, for example, in the GASB’s recent Preliminary Views¹ document. Others disagree.
17. A simple example illustrates the issue: suppose resources are obtained for CU100, prices rise so that the asset now has a value of CU120, and it is then applied in the delivery of services. The question is whether CU100 or CU120 is a more helpful (that is, more relevant and representationally faithful) depiction of the cost of delivery of services.
18. The argument in favor of historical cost would appear to be that after the transactions described in the example, the entity is CU100 poorer, which is the amount that was spent in order to obtain the resources. Of course, if current values were used the entity would also be reported as poorer by CU100. However, this would be analysed into two amounts: a holding gain arising from holding the asset during a period in which its price rises (CU20) and the cost of delivering the service which would be reported as CU120.
19. Thus current cost looks at the example as involving two events: the first is the decision to acquire and hold the asset, the second is to utilise the asset in the provision of service. (In some cases this is uncontroversial: for example where an entity buys foreign currency in anticipation of a future expense, the currency would be revalued to current rates during the period it is held, and the expense reported at the current exchange rate.)
20. Determining how much the provision of the service has cost the entity may be approached by considering the extent to which the use of the asset has made the entity worse off. As noted in the Education Session at the Naples meeting, current value seems to provide a more convincing answer than historical cost to this question. The entity can restore its position to precisely where it was immediately before the asset was used by acquiring another asset, and that will require the payment of the current, not the historical, cost.
21. Users of GPFS can be expected to wish to assess the extent to which the cost of providing services is covered by current revenues. Current revenues are usually received in cash and hence are already at current values. Financial statements prepared on a historical cost basis may indicate that current revenues exceed the cost of services, but fail to indicate that the cost of services will rise markedly when stocks already held are exhausted. (This is not always a minor issue: a government-owned power plant may build up large physical stocks of fossil fuels, correctly foreseeing a major price increase.

¹ Preliminary View of the Governmental Accounting Standards Board on Concepts Related to Recognition of Elements of Financial Statements and Measurement Approaches (June 2011).

If historical cost is used, the need to increase revenues to cover costs becomes apparent only when those new stocks at higher prices have to be acquired.²⁾

22. It would also seem that current cost provides a superior basis for assessing the likely future cost of service provision than historical cost, as the cost of future services is more likely to resemble the recent past than the remote past—and financial statements prepared on a historical cost basis do not usually provide information on the date at which services consumed in the period were acquired. Some would conclude that current costs are more decision-useful than historical cost.

Accountability

23. It was noted above that the objectives of GPFRs include providing information that is useful for accountability purposes. It is often claimed that accountability requires the use of historical cost. In particular, it is noted that use of historical cost provides a direct link to the transactions actually undertaken by the entity, whereas the use of current values obscures that link.
24. Others consider that an entity should be accountable for the current value of its assets. For example, if an asset is sold for an amount greater than its historical cost, it will report a gain, but those who support a current value approach would argue that this would be misleading, especially if the sale were for a lower amount than current value.
25. It is therefore arguable that considerations of accountability do not require the use of historical cost but do require the use of current values.
26. It may be noted that even if current values are used as the basis for financial reporting, transparent disclosure of holding gains can provide a link to previous carrying values of assets. This will reveal the extent to which the cost (or previously reported amount) has been adjusted to reflect price changes.

Summary

27. To summarize, staff consider that historical cost can only be judged superior to current values if it is considered that:
- a. Historical cost provides a more relevant and representationally faithful report of the costs incurred by the consumption of assets in the period; and
 - b. The purpose of the statement of financial position is to show the amount of assets that have been acquired to provide future services (and other economic benefits).
28. Staff considers that the discussion above shows that, in principle, current costs provide a more relevant and representationally faithful report of the costs incurred by the

² Conversely, if prices fall (contrary to expectations), the loss may be concealed under historical cost in the period in which prices change, and the cost of fuel consumption is overstated in the period when the stocks are consumed.

consumption of assets in the period. They also consider that the purpose of the statement of financial position is to show the value of assets held at the reporting date, and that current values are, in principle, more relevant and representationally faithful for that purpose. Staff therefore recommends that the objective of measurement specified in the Exposure Draft should explicitly refer to current values.

29. It should be noted that if the objective requires assets to be stated at their current value, it is implicit that those values reflect the value of the asset. Thus if current values are obtained by applying an index to past values, the index should be relevant to the specific asset: an index that reflects the general change in prices will not be appropriate.

Action Requested:

Do IPSASB members agree that the measurement objective should require the use of current values?

Market or Entity-Specific?

30. Another of the fundamental features of measurement bases discussed in CF–CP3 was whether specific measurement bases represented market or entity-specific values.
31. By their nature, historical cost is entity-specific because it reflects the actual transactions undertaken by the entity (although, as noted in CF–CP3, it will often reflect a transaction in a market). However, current values embrace both market and entity-specific values.
32. As argued in CF–CP3, there is no difference between market and entity-specific values, where assets are traded on an “ideal” market³. In such a case the entity could sell the asset, or acquire an identical asset at market value, so it cannot be argued that an asset is worth more or less to the reporting entity than market value. However, for specialised assets, i.e. assets where the utility to the reporting entity is greater than that which the asset would afford to a potential purchaser, differences between the market value and the value to the entity may arise. CF–CP3 gave the example of a prison, which any potential purchaser would have to adapt for an alternative use.
33. CF–CP3 was careful to explain that:

“As the term is used in this paper “entity-specific” refers to measurement bases that are bounded by the economic and current policy constraints that limit the possible uses of the asset by the reporting entity (and may reflect economic opportunities that would not be available to other parties), and not simply expectations and intentions.” (Paragraph 1.7, last bullet)

³ This paper does not explore the precise characteristics of an “ideal” market. The notion, however, is that of a highly liquid active market with many knowledgeable buyers and sellers, and with sufficient depth that no individual transaction significantly affects the market price.

The term “entity-specific” is used in the same sense in this memorandum. This meets the criticism that entity-specific values reflect merely the intentions or expectations of management.

Comparability and Relevance

34. The qualitative characteristics of comparability and relevance are particularly relevant to the choice between an objective based on market and entity-specific values.
35. Market values seem to offer the advantage of comparability, because two entities that own identical assets would be expected to report them at the same amounts. Stating that another way, differences between the amounts at which assets are reported by different entities may be expected to relate to differences between the assets of each entity.
36. Some consider that market values are also highly relevant. This is because market values can be reasoned to incorporate an assessment of the amount timing and certainty of all future cash flows relating to the asset.
37. However, others would question the comparability of market values in cases other than assets that are traded on an ideal market, which is particularly likely to be the case for assets held for the delivery of services. Where the utility (service potential) provided by an asset to one entity is different from that which another could derive, it is not the case that the two entities are in the same economic position, which is the implication of market values. Moreover, as Whittington has observed “comparability is of limited value if the data being compared are not relevant to the user”.⁴
38. The relevance of market values can be questioned where the entity can use a specialised asset to derive a greater value than other market participants, as in the prison example mentioned above. The use of entity-specific values can be justified in such a case because, if the asset were not owned, the entity would have to obtain similar service potential elsewhere. Conversely if the value in use to the current entity is less than market value, the most resource-efficient course of action would be to sell the asset and obtain the equivalent services at lower cost by an alternative asset. Thus the asset should be stated at net selling price: this too is an entity-specific value as it reflects the consideration that the entity will be able to obtain and is net of the transaction and selling costs that the entity would incur on making such a sale.
39. Even for financial assets entity-specific values may be more appropriate especially where the asset is not traded on a market. For example, an entity may have a debtor (or number of debtors) that it is confident will be paid promptly and on time, but where it would be difficult and costly to provide adequate evidence to another party that would persuade them to buy the assets except at a considerable discount. (IFRS 13, *Fair Value*)

⁴ Geoffrey Whittington Measurement in Financial Reporting, ABACUS, Vol. 46, No. 1, 2010, pages 104–110. This paper provides a more robust exposition of many of the arguments in this memorandum.

Measurement employs various methods of avoiding this result, but it is arguable that these are only necessary because of its objective of deriving a market value).

40. Reliability (part of the qualitative characteristic of faithful representation) is also pertinent to the choice between market and entity-specific values. Except where market values are readily available—which requires that the asset is traded on a market—use of market values requires numerous assumptions and, in some cases, the use of models. Models sometimes have to use inputs that cannot be observed on a market and complex theories (for example an option pricing model). The verifiability, understandability and reliability (and hence representational faithfulness) of such valuations is often disputed.
41. Entity-specific values may also sometimes require assumptions to be made and hence suffer from lack of verifiability and reliability. However, in many cases entity-specific values are readily available and there are established methods for establishing such values (for example, replacement cost).
42. For the above reasons, the staff proposes that the measurement objective refer to “the value to the entity.” Supporting explanation will make clear that this is in concept an entity-specific value and that it is compatible, in appropriate cases with a market value.

Action Requested:

Do IPSASB members agree that the measurement objective should seek to reflect the value to the entity?

Exit or Entry Values

43. The third general feature of measurement bases that was discussed in CF–CP3 was whether specific measurement bases represented an entry or an exit value. An entry value generally represents the cost of acquiring an asset, typically by purchase: an exit value represents the value to be obtained from an asset in the future, which is typically from sale.
44. Edwards and Bell provide a succinct explanation for the difference between entry and exit prices:

“A firm may buy a new truck at one price but an immediate decision to sell may not return to the firm the full purchase price. The difference can be regarded as a payment for the additional selling and transfer services necessary to resell the truck to another final buyer, services which the firm itself is not equipped to furnish. Such payments to people whose function it is to make markets—stockbrokers and real estate brokers are other examples—create a difference between buying and selling prices.” (The Theory and Measurement of Business Income, page 76)

45. There is a case for the general use of exit values for financial reporting.⁵ Exit values indicate the entity's financial flexibility: that is the amount that the entity can raise from existing resources if it wishes to invest in an alternative line of activity or return funds to its investors. However, it is doubtful if this is the primary interest of users of GPFs, particularly in the public sector, or that financial statements prepared wholly on an exit value basis would contribute significantly to the extent to which GPFs meet the objectives of financial reporting.
46. Entry values (in a current value framework, replacement cost) will often represent the current benefit to the entity of an asset. An entity will not incur the current cost of acquiring an asset unless the expected future benefits exceed the costs. However, receipt of those benefits is not anticipated by reflecting them in financial statements before they have been realized. (This would be the effect of general use of value in use.) An entry value reflects the cost of acquiring the asset that will, in due course, yield those benefits.⁶
47. However, the use of entry values is not appropriate in all cases. If an asset provides no service potential, the most resource-efficient course open to the entity is to sell it. More generally, sale is the most resource-efficient course to adopt whenever the value of future service potential is less than net selling price. In such cases an exit value (net selling price) represents the most relevant measurement basis.
48. Thus neither exit nor entry values are appropriate in all cases. It would therefore not be appropriate for the measurement objective to specify a preference. Rather, the objective should refer to "value to the entity". It is proposed that supporting discussion explain that the value to the entity assumes that the asset will be applied in the most resource-efficient manner, and that this consideration will guide the selection of an entry or exit value.

Action Requested:

Do IPSASB members agree that the measurement objective should not specify the general use of exit values or entry values?

Drafting of the Measurement Objective

49. A measurement objective that would reflect the above staff recommendations is:

Assets and liabilities should be stated at the amount of their current value (burden) to the entity.

⁵ Probably the best known academic proponent of exit values was Ray Chambers who advocated it under the title of "Continuously Contemporary Accounting". The general use of exit values was also proposed in the report "Making Corporate Reports Valuable" issued by The Institute of Chartered Accountants of Scotland in 1988.

⁶ For example, if a machine will reduce labour costs by CU10,000 for five years, its benefit might be quantified at the present value of those savings, say CU44,000. If the machine costs CU40,000, that is its entry value. The net savings of CU4,000 are recognized over the life of the machine.

50. Discussion at the September meeting suggested that the Exposure Draft itself should not argue from the deprival value model, but that discussion in the Basis for Conclusions should explain the extent to which the ED is consistent or inconsistent with deprival value. CF-CP3 characterized deprival value as seeking to answer the following questions (for assets), all of which are equivalent:
- What amount would just compensate the entity for the loss of the asset?
 - What loss would the entity sustain if deprived of the asset?
 - What amount would the entity rationally pay to acquire the asset (if it did not already hold it)?
51. Staff considers that the objective set out in paragraph 49 above is essentially the same as the propositions implied by those questions, especially as supplemented with supporting discussion, as envisaged.

Action Requested:

What are the views of members of the IPSAB on the objective proposed in paragraph 49?

Action Requested:

Are there any other features of measurement bases that should be referred to in the objective?

A Secondary Measurement Objective

52. If the measurement objective requires a current value, it could be applied in all cases. In particular it would be consistent with the use of market values and so would apply to assets as diverse as cash, widely traded investments as well as property plant and equipment. It would not be strictly consistent with historical cost although, as noted above, the Exposure Draft could discuss the circumstances where historical cost might be required or permitted by standards as the most practicable proxy.
53. If, however, the objective were to require the use of historical cost, then it might be thought necessary to specify a secondary objective, as historical cost might not be considered appropriate in some cases, for example:
- Obsolete or excessive inventory;
 - Financial instruments that are traded on an active market; and

- Assets of any kind that are held as investments.

Possible Distinctions

54. The GASB's Preliminary Views⁷ document suggests that:

- Assets that are used directly in providing services should be measured at initial amounts (that is, essentially, historical cost in the terminology used in this memorandum);
- Assets that will be converted into cash (for example, financial assets) should be measured at remeasured amounts (that is, essentially, current value in the terminology used in this memorandum); and
- Remeasured amounts should also be used for variable-payment liabilities, such as compensated absences or pollution remediation obligations.

55. The following paragraphs discuss other ways in which a historical objective could be combined with an alternative objective.

Market vs. Non-market

56. The objective could require the use of historical cost, except for assets that are traded on a market. If this distinction were made it would seem to be necessary to provide some guidance on the qualities of a market that would qualify for market valuation. For example, there is a reasonable market for second-hand vehicles and guides to prices are published: would prices on such a market be used? It may be noted that not all financial instruments have clear market values, for example over the counter ("OTC") derivatives, raising the question of whether such instruments should be reported at historical cost—even in cases where their current value was clearly very different. If this line is to be pursued, judgements will be necessary as to where the line should be drawn between the Framework and standards.

Financial vs. Non-financial

57. Another approach would be for the objective to specify the use of historical cost, except for financial assets and liabilities. Financial assets and liabilities might be defined in such a way as to include assets and liabilities that will be converted into cash. It would also be necessary to consider whether there are some items that are not financial instruments but for which a measurement basis other than historical cost would be preferred, such as forward contracts to buy non-financial assets, and non-financial investments, such as investment properties.

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Preliminary View of the Governmental Accounting Standards Board on Concepts Related to Recognition of Elements of Financial Statements and Measurement Approaches (June 2011).

Operating vs. Investing

58. Another way of expressing the distinction would be to draw a distinction between assets for operating (service delivery) purposes and those used for investing (which would presumably include assets held for disposal). Historical cost would be required for operating assets, and current values used for investing purposes. In practice, the distinction between operating and investing activities is not always clear-cut. There is a danger that standards would have to set out detailed rules to provide adequate guidance.

Variable-Payment Liabilities

59. Staff agree with the position in the GASB's Preliminary Views that historical costs are unlikely to be the most appropriate basis for measuring variable-payment liabilities (which seem to include some cases, for example pollution remediation liabilities, where the liability may be settled by the provision of services rather than the payment of cash. These liabilities will at least sometimes have no clear market value, are non-financial and relate to operations. Thus it would seem to be necessary to include a third category in the measurement objective.

Action Requested:

Do members of the IPSAB agree that a secondary objective is necessary if the objective is to refer to historical cost?

Action Requested:

What are the views of IPSASB members as to the circumstances in which that secondary objective would apply?

Issues Paper

Conceptual Framework, Phase 3: A Possible Outline of an Exposure Draft

Note:

This outline is presented to stimulate discussion by members of the IPSASB. It is inevitable that the outline will evolve as the Exposure Draft is developed.

Introduction

1. At the September meeting in Toronto it was indicated that Board members would find it helpful if staff shared their ideas for the content and structure of the Exposure Draft. This possible outline responds to that request.
2. It will be appreciated that the ideas presented here are preliminary. It has been necessary to assume that the IPSASB agrees with the staff recommendations to this meeting; this is, of course, not intended to pre-judge the outcome of the discussion at this meeting. In particular, the outline does not make room for a secondary measurement objective. In any case, it is inevitable that the outline will evolve as the Exposure Draft is developed.
3. The major sections in the draft outline are:
 - 1 An introduction.
 - 2 The measurement objective.
 - 3 Specific measurement bases.
 - 4 Liabilities.
4. The specific measurement bases discussed in Section 3 are: historical cost; market value; fair value; replacement cost; value in use; and net selling price. These bases, with suitable adaption of the terminology are also discussed in relation to liabilities in Section 4.
5. The draft outline suggests a consistent structure will be used for each measurement bases, as follows:
 - a. What is the basis?—a description or definition;
 - b. Relationship of the basis to the measurement objective, and the qualitative characteristics;
 - c. Circumstances where that measurement basis is likely or unlikely to be appropriate.

6. This consistent structure will make the discussion easier to follow. It also tends to promote objectivity, by showing that equal consideration is given to each measurement basis.
7. It will be noted that fair value (in the sense used in IFRS 13, *Fair Value Measurement* that is, an exit value) features as a measurement basis in the body of the Exposure Draft. However, the conceptual merits of fair value compared with other current measurement bases are few. The outline suggests that fair value may be used where it is little different from market value and “where necessary for convergence with IFRS.” Arguably neither of these are conceptual considerations.
8. It may also be noted that the role of value in use has been restricted. In particular it is suggested that where an asset that is not cash-generating has become impaired because of reduced demand for its service potential, the most relevant measurement basis may be the replacement cost for the service potential that the entity will be able to use, rather than value in use. This is consistent with IPSAS 21, *Impairment of Non-Cash-Generating Assets*.
9. A more detailed explanation of the possible content of the Exposure Draft is set out in the Appendix.

Action Requested:

What are the views of IPSASB members on the draft outline?

Action Requested:

Are IPSASB members content with the treatment of fair value, including the comment that it might be used where necessary for convergence with IFRS?

Action Requested:

Do IPSASB members agree with the use of replacement cost for impaired assets where there has been a fall in demand for the service potential?

Action Requested:

Are there any issues that should be dealt with that are not covered in the draft outline?

Appendix

Draft Outline of Exposure Draft

Section 1: Introduction

Exposure Draft

- 1.1 The role of measurement in GPFRs: stating the amount of: assets and liabilities and costs and income.
- 1.2 Objectives and qualitative characteristics of financial reporting (a recap).

Basis for Conclusions

[None?]

Section 2: The Measurement Objective

Exposure Draft

- 2.1 The role and purpose of the measurement objective: **to guide the selection of a measurement basis in the development of accounting standards.**
- 2.2 Statement of the measurement objective:

Assets and liabilities should be stated at the amount of their current value (burden) to the entity.
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- 2.3 Relationship to the objectives of financial reporting and qualitative characteristics: decision usefulness and accountability.
- 2.4 Expansion of “current value”: reflects the conditions prevailing at the reporting date.
- 2.5 Discussion of “to the entity”—requires that the entity can obtain that value:
 - Values are entity specific; and
 - Value cannot exceed recoverable amount.
- 2.6 Entry or exit values?
 - Assumption that entity will deploy the asset in the most resource-efficient manner. This will not necessarily be the same as the intended deployment of the asset (although it usually is).
 - Hence choice between entry and exit values depends on specific circumstances (but often will be an entry value).
 - Treatment of transaction costs (need to be included in an entry value and deducted in an exit value).
- 2.7 Relevance of costs measured in current values:
 - Separation of holding gains from changes due to consumption/inflows.
 - Ambiguity of holding gains (are they part of performance?).

2.8 Relationship of the objective to concepts of capital and capital maintenance.

Basis for Conclusions

BC2.1 Why a measurement objective?

- Summary of SMC 1 and decisions made in the light of responses.

BC2.2 Discussion of current and historical values:

- Relevance in the statement of financial position.
- Comparability.
- Relevance of costs reported on historical and current bases.
 - Where current values are used, need to distinguish holding gains and losses from costs of consumption.
- Faithful representation.
- Understandability.
- Timeliness.
- Verifiability.
- Constraints on information.
- Timeliness of recognition of gains and losses.
- Accountability.
- Use of current values in the measurement objective does not preclude use of historical cost as a proxy.

BC2.3 Discussion of entity-specific and market values:

- Comparability.
- Relevance.

BC2.4 Entry and exit values:

- Reasons for differences.
- Relevance.
 - Exit values always have some relevance.

BC2.5 Concepts of capital and capital maintenance.

Section 3: Specific Measurement Bases (Assets)

Exposure Draft

3.1 Relationship between specific measurement bases and measurement objective.

3.2 Identification of different measurement bases does not remove the need for judgement—in particular to judge the best balance between different qualitative characteristics.

...

Historical Cost

- 3.11 *Description:* assets stated at amount paid for their acquisition (subject to adjustment for depreciation/amortization):
- Assets received by donation (or on subsidized terms) initially recognised at value at time of receipt (with a gain).
- 3.12 *Relationship to objective and QCs:* HC can be reasoned to show the value to the entity of the asset at the time it is acquired. Often there is no basis on which to develop a superior measure of this. But does not reflect changes in prices, and is not therefore a current value.
- Simplicity contributes to timeliness.
 - Recoverability requires consideration.
- 3.13 *When appropriate:* when cost-benefit considerations suggest there is little net benefit in quantifying the effect of price changes (e.g., when changes in prices are unlikely to be significant; or when current values cannot be obtained at reasonable cost), and when there is adequate evidence of recoverability.

Market Values

- 3.21 *Definition/description:* (deep, liquid, active markets etc).
- 3.22 *Relationship to objective and QCs:* Where available, meet the measurement objective.
- In these cases may be most cost effective, simple and understandable basis.
- 3.23 Consistent with “entity-specific” values (where the entity has access to the market).
- 3.24 Does not resolve entry/exit issue.
- 3.25 *When appropriate:* When “adequate” markets exist.
- Question use of estimated market values, especially when derived from models.

“Fair Value”

- 3.31 *Definition/description:*
- Definition in existing IPSASs: willing buyer/willing seller.
 - Somewhat vague and imprecise (especially on entry vs. exit) (hence IASB-FASB project to clarify).
 - Definition in IFRS 13: Explicitly an exit value: this is what is discussed here.
- 3.32 *Relationship to objective and QCs:* A market value, but may differ significantly for “specialized” assets from entity-specific measures.
- Also an entry value, which will not always be appropriate (as explained above).

- 3.33 *When appropriate:* May be similar to market values in some cases. May also be used where necessary for convergence with IFRS.

Replacement Cost

- 3.41 *Definition:* “The most economic cost required for the entity to replace the service potential of an asset (including the amount that the entity will receive from its disposal at the end of its useful life) at the reporting date” (from CF–CP3).
- 3.42 Expansion/commentary on the definition:
- “Most economic cost”.
 - “Service potential”: that which the entity will be able to use.
- 3.43 Conceptual case for replacement cost:
- An entry value.
 - Represents benefit of ownership and cost of consumption.
 - Sets a ceiling on the value of an asset.
- 3.25 Relevant service potential is that which the entity is able to use. Hence may be used for impaired assets, when impairment is caused by a fall in demand for the service potential of an asset.
- 3.24 Complexity, unavailability:
- Assets subject to technological change.

Value in Use

- 3.51 *Definition:* “The present value to the entity of the asset’s remaining service potential if it continues to be used, and the net amount that the entity will receive from its disposal at the end of its useful life” (from CF–CP3).
- 3.52 *Relationship to objective and QCs:* Represents a current value. When (as will typically be the case value in use exceeds replacement cost will be greater than value to the entity, which is represented by replacement cost.
- May be difficult to quantify (hence low verifiability, timeliness) except for assets that generate discrete cash flows from transactions on commercial terms.
 - For other assets, replacement cost may provide a more relevant measure, especially if “service potential” is (as it should be) confined to the service potential that the entity is able to use.
- 3.53 *When appropriate:* Only for assets that generate cash flows from transactions on market terms, and where less than replacement cost.

Net Selling Price

- 3.61 *Definition:* “The net amount that the entity could obtain from sale of the asset at the reporting date” (from CF–CP3).

3.62 *Relationship to objective and QCs:* Net selling price is a current price (reflects prices at the reporting date. It will represent value to the entity only where sale without further use is the most resource-efficient use of the asset (and, as is usually the case, lower than replacement cost).

3.63 *When appropriate:* For assets where sale (on arms-length terms) without further use is the most resource efficient use of the asset. (For example, assets at the end of their useful life, obsolete or surplus inventories.)

Basis for Conclusions

BC3.1 The selected measurement bases are those most often suggested to meet the measurement objective.

BC3.2 A focus on values that are entity-specific is necessary in order to ensure values are relevant.

BC3.3 The idea of resource–efficiency is needed to focus on the asset that is currently held, and not to anticipate the effect of future actions (even if already contemplated).

BC3.4 Much of what is said is consistent with the deprival value model, especially the use of replacement cost. However, the deprival value model has been adapted by embracing the use of replacement cost for reduced service potential, where impairment is caused by a fall in demand.

Section 4: Specific Measurement Bases (Liabilities)

Exposure Draft

4.1 Similar principles to assets apply.

4.2 A review of the same measurement bases, as for historical cost, with some changes in terminology.

4.3 Historical cost as for assets, but note that value needs updating for variable liabilities (e.g., pensions).

4.4 Market value—as for assets.

4.5 Fair value—as for assets.

4.6 Assumption price (corresponds to replacement cost). Does not occur often in public sector but may be used for liabilities to provide services in the future.

4.7 Cost of fulfilment (corresponds to value in use) appropriate where settlement by the entity is the most resource-efficient course. Does not include an allowance for profit distinct from cost of risk-bearing.

4.8 Cost of release. Appropriate when seeking release is the most resource-efficient course (e.g., a lawsuit that is best settled).

**Review of Responses to Conceptual Framework Phase 3 Consultation Paper
Extract of Draft Minutes of IPSASB September 2011 Meeting
(Note: these draft minutes have not yet been approved by the IPSASB)**

6.5 Discuss Responses to Phase 3 Consultation Paper (Agenda Item 4D)

The Chair welcomed Andrew Lennard, Director of Research at the United Kingdom Accounting Standards Board, to present the session and thanked Andrew for the work undertaken on the initial analysis of comments on the Phase 3 Consultation Paper (CF-CP3). The contribution of Yangchun Lu in compiling the collation of responses was acknowledged. As at August 25, 2011 35 responses had been received to CF-CP3.

General comments

A Member commented that it would be helpful if Andrew explained how he envisaged the structure of the Phase 3 Exposure Draft (CF-CP3). Andrew indicated that an outline of CF-CP3 would be brought to the December meeting.

Specific Matters for Comment (SMCs) 4 and 5

SMCs 4 and 5 dealt with two discrete issues:

- (i) the treatment of an entity's own credit risk; and
- (ii) the basis of measurement of assets that are not restricted in use and may be sold for an alternative use.

Andrew explained that a preliminary collation and classification of the responses on these SMCs had been carried out and included in the agenda papers. However, there had not been any further detailed analysis. He suggested that these SMCs could be discussed at the December 2011 meeting. The Coordinator noted that some respondents had suggested that these were both standards-level issues and that staff had found such a view quite persuasive. He considered that, if the IPSASB agreed with this view, it might not be a good use of Board time to spend much time on them at the December meeting, but to return to these issues if necessary. There was a certain amount of agreement with this view, but no decision was made.

A measurement objective

It was noted that some respondents had argued that a measurement objective needs to be determined. Many had also acknowledged that the Framework should not attempt to establish a firm requirement that a particular measurement basis or combination of measurement bases should always be used. Andrew said that his view had been that it would be inappropriate to establish a measurement objective, but that analysis of the responses had led him to modify this view. Although the deprival value model had received little direct support from respondents, components of that model might be useful in framing a measurement objective (see also below section on deprival value).

A number of Members supported establishing a measurement objective or objectives in CF-ED3. It was further suggested that a strong Basis for Conclusions will help the IPSASB in determining future standards-level measurement requirements. The Chair also supported development of a measurement objective, but commented that he considered

that this would be difficult and noted that respondents had not provided much of a lead on the approach to be adopted.

Another Member put forward two objectives related to:

- (a) A financial concept of capital; and
- (b) A physical concept of capital.

He considered that these two objectives would result in different measurement bases. He also considered that having a measurement objective would connect this Phase of the project to Phase 1, which addresses the objectives of financial reporting.

Concepts of capital and capital maintenance

Andrew commented that the discussion of concepts of capital in CF-CP3 was clearly not detailed enough for some respondents, but asked Members whether the inclusion of a discussion of concepts of capital should be within the body of CF-ED3 or whether any discussion should be limited to the Basis for Conclusions. There was some variation in the emphasis that Members gave to concepts of capital. Members made the following comments:

- One Member was not supportive of having concepts of capital driving the selection of a measurement basis, but accepted the need for a discussion in the Basis for Conclusions;
- Another Member suggested that concepts of capital are being used as a surrogate for determining “what is the statement of financial position trying to give me a picture of” (e.g., whether the statement of financial position primarily reflects service capacity or the entity’s ability to meet its commitments);
- The Chair commented that this discussion is related to the assets and liabilities-led (A&L-led) and revenue and expenses-led (R& E-led) approaches set out in CF-CP2. Discussion in CF-ED3 would need to be consistent with the tentative conclusions in Phase 2; and
- A further view was that it is almost inevitable that the IPSASB needs to include a discussion on concepts of capital, but that there are significant differences to these concepts when applied to the public sector. The Chair added that there is very little research on concepts of capital as they relate to the public sector and that as a result, these concepts have not influenced the development of accounting or economics in the public sector.

Andrew proposed that there would be a couple of paragraphs in the body of CF-ED3 and approximately 8–10 paragraphs in the Basis for Conclusions on this issue.

Reporting changes in the amounts of assets and liabilities

Andrew commented that the omission of a discussion on how changes in measurement would be dealt with in the financial statements had unsettled some respondents. He asked Members whether a discussion of changes in carrying values should be included in

CF-ED3 (e.g., whether changes related to replacement cost should be charged to revenue). It was acknowledged that the IPSASB should be responsive to respondents' comments and accepted that there can be some difficulty in visualizing concepts. However, there were concerns that such discussion was likely to stray into the territory of Phase 4: Presentation. A further observation was that this issue is strongly linked to the A&L-led and the R&E-led approaches set out in CF-CP2. It was therefore agreed that CF-ED3 should not go into any detail on this area.

The choice of specific bases (and combination of bases)

Andrew noted that there was a wide variation in views relating to the choice of a specific measurement basis and whether there should be a combination of measurement bases.

Historical cost

Andrew noted that there was strong support for historical cost. A number of respondents considered that historical cost is the only measurement basis that is consistent with the objective of accountability. He expressed a view that constituents need some sort of assurance that IPSASB does not have an intention to eliminate historical cost as a measurement basis at the standards level. The points arising in discussion included:

- The Chair highlighted that historical cost is seen as being very important to respondents (i.e., it is very much “alive”). The IPSASB needs to acknowledge this view. He pointed out that this view contrasts with the view of the demise of historical cost in much of the academic literature;
- Andrew noted that it would be difficult to develop a single measurement objective that included both historical cost and replacement cost. The Basis for Conclusions would need to be carefully worded in discussing historical cost;
- The relationship between historical cost and accountability was further considered. It was suggested that CF-ED3 should include an explanation about the use of historical cost but that did not mean that it should necessarily be used as a measurement basis in perpetuity. The view that historical cost is the only measurement basis compatible with the accountability objective was challenged using the example of an entity that had purchased a building for Currency Units (CU)1 million, which is now worth CU10 million. It was strongly arguable that the entity is now accountable for a building worth CU10 million.
- Based on the views of participants in his outreach activities on this topic a Member challenged the view that historical cost is more relevant than a current value measurement basis. An explanation should be included in the Basis for Conclusions whether there are any circumstances where historical cost is more relevant than the other measurement bases (i.e., other than for cost-benefit or timeliness reasons).
- While the characteristics of different measurement bases are well known, it is still useful to include a description of these bases in CF-ED3. However, this description will not help in choosing which measurement basis to use. A view was expressed that CF-ED3 should include a discussion relating measurement bases to concepts of capital and a discussion of the extent to which each measurement basis could be used as an acceptable proxy for another basis. However, it was pointed out that in the

earlier discussion on concepts of capital other Members were not enthusiastic about such an approach.

Andrew summarized the position on historical cost by suggesting that key issue is its relevance; some respondents see it as the best basis to use for the measurement of the cost of service delivery and consequently for accountability purposes. In their view, current values are more useful for predicting the future, but do not say much about the past. Others consider current values to be relevant for determining the cost of services and for assessing accountability, and do not accept that it is only relevant for predicting the future.

Fair value

Andrew noted that there was a highly limited consideration of fair value in CF-CP3. One of the reasons was that, when it was issued, the IASB had not finalized its project on the measurement of fair value. He added that the IASB's project was at a standards level and therefore it includes very limited discussion on why fair value is a good measurement basis to use. There was significant variation in the views expressed by Members, TAs and Observers. The points arising in discussion included:

- There was considerable agreement with the view of a number of respondents that fair value had not been addressed in sufficient detail in CF-CP3 and some support for the inclusion of a discussion of fair value in the body of CF-ED3, rather than just in the Basis for Conclusions, together with a view that it is important that any discussion on fair value is linked to market value;
- Some further concerns were expressed that the IPSASB is not paying sufficient attention to comments from those respondents who had questioned whether there is enough justification for the IPSASB to diverge from the IASB in this area. Conversely, the view was expressed that CF-ED3 should acknowledge that there are problems with the application of fair value in the public sector. It was also pointed out that the IASB does not mention fair value in its current Conceptual Framework and that the use of fair value first occurred when IASB was developing its standards on financial instruments;
- A view was expressed that that a discussion contrasting market value and replacement cost would be more helpful than a discussion of fair value;
- The Chair commented that the problem the IASB has encountered with the application of fair value relates to non-liquid markets (e.g., some of the government bonds held by banks in Europe). In such cases assumptions have to be made using models. He considered that this reflected an underlying conceptual problem;
- It was cautioned that the IPSASB must have a good rationale in the Basis for Conclusions if it decides that the Conceptual Framework should not be consistent with existing IPSASs, which are based on IFRSs. The Chair added that this was an important point and it would not be easy for the IPSASB to make a decision to differ from IFRSs. He suggested that the discussion of fair value in CF-ED3 will need to include consideration of both exit and entry values;

- It was noted that Phase 1 of the project has recognized that, where there are conflicts between IPSASs and the finalized Conceptual Framework, the IPSASs will be reviewed, and this applies to conflicts arising from Phase 3: Measurement phase;
- It was noted that Government Finance Statistics (GFS) places considerable reliance on market values and suggested that CF-ED3 should include some discussion of the approach in GFS. An observer added that GFS uses current market values except for loans which are held at nominal value; and
- It was cautioned that the IPSASB needs to be satisfied that the choice of measurement bases will deal with the measurement issues related to financial instruments.

Deprival value

Andrew noted that there were a number of non-supportive views on the deprival value model and a Member further emphasized that there was not much support for the deprival value model from respondents. Andrew suggested that it may not be appropriate to include discussion of this model in the body of CF-ED3, but that the Basis for Conclusions could explain the extent to which proposals are consistent with the deprival value model. Members made the following comments:

- The view that the deprival value model was not useful was questioned as it uses replacement cost which is used in the IPSASB's existing standards to determine value in use;
- It was questioned whether the deprival value model for individual assets was impracticable for accountability purposes as similar assets could be valued differently; and
- It was also noted that the deprival value model is unfamiliar in certain jurisdictions, such as Switzerland.

The Chair suggested that the IPSASB needed to be mindful of respondents' concerns relating to the deprival value model and at this stage, the IPSASB should continue to discuss it, but it should not be the only model to use. He considered that discussion of this model should be related to the analysis of measurement bases. He further suggested that the IPSASB needs to develop a view on liabilities and that CF-ED3 needs to include a discussion of how liabilities are measured in GFS.

Andrew summarized the IPSASB's directions arising from this session. The body of the ED will:

- Start by deriving a measurement objective, including a link to the objectives of GPFs;
- Discuss the use of current values compared with historical cost, including the use of entity-specific values;
- Work through different measurement bases and evaluate the extent to which they meet the measurement objective; and

- Separately discuss liabilities.

The Basis of Conclusions will outline the deprival value model and explain how it relates to the body of CF-ED3 and indicate how the IPSASB has addressed the concerns of respondents. The IPSASB was generally supportive of this approach. Members emphasized that:

- The TBG should be involved in the development of CF-ED3; and
- Fair value needs to be addressed both in the body of the document and in the Basis for Conclusions.