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This paper is a very early draft of part of the Conceptual Framework discussion paper. It has been prepared by the staff for discussion by the IASB. Issues discussed and conclusions reached will be subject to change.

Measurement Principles

Summary of this section

This section discusses:

Principles for identifying appropriate measurement methods

1. The objective of measurement is to represent faithfully the most relevant information about the economic resources of the reporting entity, the claims against the entity, and how efficiently the entity's management and governing IASB have discharged their responsibilities to use the entity's resources.

2. Although measurement generally starts with an item in the statement of financial position, the relevance of information provided by a particular measurement method also depends on how it affects the statement of comprehensive income and if applicable, the statements of cash flows and equity and the notes to the financial statements.

3. The cost of a particular measurement must be justified by the benefits of that

information to existing and potential investors, lenders, and other creditors of reporting that information.

The premise that the IASB will not select the same measure for all items in statement of financial position and statement of comprehensive income

The types of measures that are appropriate for use in financial reports

Nb measurement also refers to amounts used in disclosure

1. Financial statements provide information about the economic resources of a reporting entity, the claims against that reporting entity and the effects of transactions and other events and conditions that change those resources and claims.[1]

2. Those resources, claims, and effects are represented using words and numbers. The numbers used on the face of each financial statement and some of the numbers in the notes are referred to in this Framework as *measures*¸ and the term *measurement* is used to describe the process of determining which numbers to present or disclose.[2]

3. Appendix [not included in this draft] lists the measures currently used in IFRSs.

4. The discussion in this DP is based on the premise that the IASB will not select the same measure for all items in statement of financial position and statement of comprehensive income. For reasons that are made apparent by the later discussion in this DP, that outcome is neither possible nor desirable at this time, if ever.

[1] QC2

[2] Paragraph 4.54 of the existing framework defines measurement as 'the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the balance sheet and income statement'.

Question 1

Does the IASB agree that there is no single measurement method that will provide users with the most relevant information for all assets and liabilities in all circumstances?

Three fundamental principles derived from the objectives and qualitative characteristics

5. The following three fundamental principles of measurement are derived from the objectives of financial reporting and the qualitative characteristics of useful financial information as described in Chapters 1 and 3 of the Framework.

   (a) *Principle 1:* The objective of measurement is to represent faithfully the most relevant information about the economic resources of the reporting entity, the claims against the entity, and how efficiently the entity's management and governing board have discharged their responsibilities to use the entity's resources.

   (b) *Principle 2:* Although measurement generally starts with an item in the statement of financial position, the relevance of information provided by a particular measurement method also depends on how it affects the statement of comprehensive income and if applicable, the statements of cash flows and of equity and the notes to the financial statements.

   (c) *Principle 3:* The cost of a particular measurement must be justified by the benefits of that information to existing and potential investors, lenders, and other creditors of reporting that information.

6. Principle 1 comes from the needs of existing and potential investors, lenders, and other creditors as described in paragraph OB4 (Chapter 1) of the *Framework* and the definition of relevance in paragraph QC6 (Chapter 3) of the *Framework*. That principle applies to measurement (and every other aspect of the *Framework*).

7. Principle 1 is expressed as an objective because if the cost of the most relevant measure in a specific circumstance is high and there is an alternative measure that also is relevant, the incremental benefit of the most relevant measure (as compared to the alternative relevant measure) may not justify its cost.

8. Principle 2 is derived from the discussion of faithful representation in paragraph QC13 (Chapter 3) of the *Framework*, which states:

> A complete depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations.

"All information necessary…to understand" changes in the cash flow generating capacity of an asset or liability includes information from the statement of financial position, the statement of comprehensive income, the statement of cash flows (which usually is unaffected by differences in measures), and the notes to the financial statements. Consequently, the IASB has to consider all of those in choosing appropriate measures.

9. Principle 3 is from the discussion of the cost constraint which begins in paragraph QC35 of the *Framework*.

Judgments required to apply the three fundamental principles

10. All the three principles should be considered by the IASB when selecting an appropriate measure. None is automatically higher priority than the others. If the three do not point to a single measure in a particular instance, the IASB will need to make judgments about the weights of different factors. At least two important judgments about relative weights are likely to be required with some frequency.

11. Determining whether benefits justify costs (the trade-off between Principle 1 and Principle 3) is the first such judgment. Unfortunately, concepts cannot provide more guidance to the IASB in making such judgments. They will necessarily require careful consideration of all the facts the IASB can reasonably gather in each instance.

12. The other important judgment will be required by Principle 2 if one measure is judged to provide the most relevant information about financial position and another is judged to provide the most relevant information about comprehensive income. Proponents of fair value tend to focus first on the statement of financial position and proponents of cost-based measures tend to focus first on the statement of comprehensive income. The relative importance of the two

statements has been debated for decades without either side persuading the other side or those who contend that the two each are important for different reasons.

13. Both the statement of financial position and the statement of comprehensive income provide relevant information for users. Selecting measurements by considering either the statement of financial position alone or the statement of comprehensive income alone usually will not produce the most relevant information for investing and credit decisions.

14. The statement of financial position portrays a reporting entity's resources and claims against the entity. The statement of comprehensive income portrays the value flows to and from the entity and the changes in value of the entity's resources between two reporting periods. Each statement provides relevant information, but at times the choice of a measure may depend more on one than the other.

15. Guidelines for making the judgment required by Principle 2 are discussed in AP3G *Draft discussion paper: Initial and subsequent measurement*.

Question 2
Does the IASB agree with the three principles in paragraph 5 and the related discussion in paragraphs 6 - 15?

Other observations about selecting appropriate measurements

16. While not as fundamental as the three principles already discussed and not derived from other concepts, the following are some 'common-sense' observations about measurement and reporting changes in measures that are based on standard setter experience. The IASB considers these points when establishing requirements for measurement, presentation and disclosure:

    (a) Gains and losses reported because of changes from one measurement method to another may mislead users.

    (b) The cost of using one measure of an item in the statement of financial position and providing a second measure in notes probably would not be justified by the benefits in many cases.

(c) As the number of different measures in a set of financial statements decreases, the information becomes easier to understand. Therefore, the number of different measures used should be the minimum number necessary to provide relevant information.

17. Changing the way an item is measured often requires reporting a gain or loss that does not reflect an economic phenomenon or reflects an economic phenomenon of a different period. In fact, a cumulative gain may be reported even though a loss would have been reported in the current period if the new measure had been used in prior periods. Therefore, changes in measurement method should be avoided whenever possible, and if a change is considered a necessary improvement, clear explanation should be provided. (This discussion of changes in measurement method relates to changes within continuing accounting requirements. It does not relate to changes in accounting standards.)

Question 3
Does the IASB agree with the three observations in paragraph 16 and the related discussion in paragraph 17?

Cost

18. Most IFRSs require cost-based or fair value measurement, and much of the discussion in this paper involves one or both of those measures.[3] They are used as they are defined in the IASB *Glossary of terms* and IFRS 13, *Fair value measurement*.

19. The definition of cost in the IASB's *Glossary of terms,* IAS 16 *Property, Plant and Equipment*, IAS 38 *Intangible Assets* and IAS 40 *Investment Property* is:

> the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction, or, when applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRSs, eg IFRS 2.

[3] Other current or possible measures are discussed beginning in paragraphs 27 -28.

There is not an analogous definition for a liability, but if there were, it would refer to fair value of consideration received at the time a liability is incurred or assumed.

20. IAS 2 *Inventories* states that cost includes costs of purchase, costs of conversion and all other costs incurred in bringing inventories to their present location and condition. IAS 2 and IAS 16 also specify what is to be included in cost.

21. The initial measures at cost of assets and liabilities are adjusted over time in a variety of ways. The most common are:

    (a) Consumption or expiration of useful life of assets: depreciation or amortization;

    (b) Time value adjustments for assets or liabilities: accrual of interest, accretion of discount, or amortization of premium;

    (c) Adjustments for non-recoverability of assets' carrying values or inadequacy of liabilities' carrying values.

22. In some cases, cost is not simply the fair value of the consideration given to a seller or received from a creditor, but for purposes of subsequent measurement based on cost, the way cost is determined initially does not matter. Those cases are discussed in the context of initial measurement in AP 3G *Draft discussion paper: Initial and subsequent measurement*.

Fair value

23. IFRS 13 defines fair value as 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'.

24. The phrase *orderly transaction* implies that neither participant is desperate or otherwise has an unusually weak bargaining position because it is forced to sell or buy quickly because of financial distress or other factors.

25. Prices in orderly transactions normally reflect the following factors:

    (a) Market participants' collective views about probable amounts of future cash flows;

(b) Time value of money;

(c) Market participants' collective views about the appropriate return for bearing risk;

(d) Market participants' collective views about appropriate level of any other return demanded by potential buyers.

26. Those factors are reflected in observed prices, but if an entity must make an estimate of a price using inputs other than observed prices, they must be considered explicitly.

Other measures [to be discussed at the March meeting]

27. This section will discuss specialised measurement methods for circumstances in which there is no cost or in which cost-based measures are not considered appropriate, and fair value is either inappropriate or too expensive. The measures to be discussed will include some or all of the following:

(a) Entity specific measures that involve discounted cash flows (such as value in use for assets and fulfilment value for liabilities);

(b) Current prices other than fair value (such as entry price/replacement cost);

(c) Carrying amounts that are updated for some but not all current market factors or entity-specific estimates.

28. This section will also discuss considerations that might make these measures appropriate such as hedge accounting, contractual links between assets and liabilities, and other matters.