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Agenda Item

4B

Date: May 21, 2012
Memo to: Members of the IPSASB
From: Andrew Lennard
Subject: Draft Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities Phase 3: *Measurement of Assets and Liabilities in Financial Statements*

Objective of this Session

1. The objective of this session is to **review** the draft of the Phase 3 Exposure Draft of the Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: *Measurement of Assets and Liabilities in Financial Statements*; and **provide** directions for further development.

Agenda Material

2. Agenda material:
 - 4B.1 First draft of an Exposure Draft of Phase 3 of the Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: *Measurement of Assets and Liabilities in Financial Statements* (draft Exposure Draft)
3. Other relevant materials previously distributed:
 - Staff summary and collation of responses received (posted with September 2011 Agenda materials);
 - Overview of responses by geographic location, function and language (posted with September 2011 Agenda materials);
 - A copy of Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities, Consultation Paper: *Measurement of Assets and Liabilities in Financial Statements* (CF-CP3); and
 - A copy of all submissions received.
4. Staff would like to record their appreciation of the contribution made by John Stanford who has been an unflagging source of help, advice and support in the development of the draft Exposure Draft, and of the Task Based Group who have provided detailed and thoughtful comments on successive drafts.
5. The draft is not complete in all respects. For example, background on the Framework, Specific Matters for Comment, and a note on the statistical bases of reporting remain outstanding. The draft will also need updating if deferred inflows and outflows are to be defined as elements. This is noted in one or two places in the draft, but there may be others that will also need reconsideration.

Background

6. The draft Exposure Draft discusses a number of measurement bases and seeks to provide a helpful discussion of the circumstances in which they may be relevant.
7. The bases that are addressed are the same as those in CF–CP3. However, as is explained in a later section of this memorandum, the term “current exchange value” has been used in place of “market value.”
8. Consistent with the Board’s discussion in Brasilia in December 2011, the draft Exposure Draft itself does not discuss the deprival value model. However, the deprival value model is discussed in the Basis for Conclusions.

Approach taken in the Draft Exposure Draft

9. In Brasilia, the Board decided that the Exposure Draft should not propose an overarching measurement objective. Instead, the discussion of each of the measurement bases should be driven by a consideration of the objectives of financial reporting and the qualitative characteristics (QCs).
10. Phase 1 of the Framework gives a lengthy and extensive review of the objectives of financial reporting and the needs of users. To make clear how the discussion of measurement bases relates to that discussion, it was necessary to distill the key points that had implications for measurement. Thus paragraph 1.3 identifies seven issues that seem to be particularly relevant in the context of a selection of a measurement basis. The next paragraph (1.4) further reduces this to three key items:
 - (a) The cost of services provided in the period, and in particular:
 - An appropriate comparison with the amount of taxes and other income received in the period; and
 - Whether resources have been used economically and efficiently.
 - (b) Operational capacity: the resources available to provide services in future periods.
 - (c) Financial capacity: the capacity of the entity to continue to fund its activities, and meet financial claims on its resources; and financial flexibility: the capacity of the entity to adapt to changing circumstances.
11. It is then stated that “the relevance of a measurement basis may be assessed by considering the extent to which it provides information on the above factors.”
12. One TBG member has suggested that some of the items identified in paragraphs 1.3 and 1.4 are relevant to long-term fiscal sustainability rather than general purpose financial statements. Another has suggested that the flow from paragraph 1.3 to 1.4 is unclear.
13. Discussion of the QCs other than relevance could quickly become both inconclusive and repetitive. To reduce this, the Introduction suggests that, in the context of the selection of a measurement basis, the extent to which information possesses the QCs is affected by complexity and subjectivity. The main exception to this is comparability: a measurement basis may be simple and objective and yet still not comparable.
14. This Introduction has provided a rationale for a structure for the discussion of each measurement basis, as follows:

- A definition and/or description of the measurement basis;
 - Relevance:
 - Costs of services;
 - Operating capacity; and
 - Financial capacity and financial flexibility; and
 - Complexity, subjectivity and the qualitative characteristics.
15. This structure has been used consistently for each measurement basis, subject to the points mentioned in the next paragraph. A consistent structure seems desirable, as it should make the Chapter easier to follow; assists comparison between different bases and provides a safeguard against unintended bias. It may also assist in ensuring that the discussion is complete.
16. Mindful of Orwell's rule 6 (*"Break any of these [above] rules sooner than saying anything outright barbarous"*) the structure has been adapted where necessary. The differences in the discussion of measurement bases are as follows:
- For each measurement basis there some general observations on relevance are made before reaching "costs of services." There are no general observations for historical cost.
 - Conversely for value in use there is only a general discussion and the specific issues to which a measurement basis might be relevant are not discussed. This is because value in use is incapable of application except in conjunction with other measurement bases.
 - For current exchange value (only) the discussion under the heading "Complexity, Subjectivity and the Qualitative Characteristics" has been sub-divided. The sub-divisions are: ideal market values; estimated market values; and notional market values. This permits a discussion that highlights how the extent to which current exchange values provide information that meets the QCs varies in different circumstances.
17. The draft Exposure Draft begins with an Introduction, the main points of which have been summarized above. Liabilities are dealt with in a final section. The Basis for Conclusions is presented separately. Appendices deal with the relationship to the IASB's Conceptual Framework and the Statistical Bases of Reporting. (The latter has yet to be prepared).

Action Requested:

Members are requested to **confirm** that they are content with linkages established in the draft Exposure Draft between the objectives of financial reporting, the qualitative characteristics and the measurement bases, or to **provide** directions for their improvement.

Members are also requested to **confirm** that they are content with (i) the structure of the discussion of each measurement basis and (ii) the overall structure of the Exposure Draft; or to provide directions for their improvement.

Historical Cost

18. Section 2 of the Exposure Draft deals with historical cost as a measurement basis. Some TBG members have questioned whether the discussion is balanced.

19. In particular, TBG members had qualms about the thought in paragraph 2.4. In short, that paragraph says that, because historical cost does not reflect the value of an asset at the time it is consumed, but only its value at an earlier date, historical cost does not provide useful information on the cost of services if price changes are significant. Similarly, if price changes are significant, historical cost does not reflect the value of an asset at the reporting date.

Action Requested:

Members are requested to **confirm** that they are content with the message of Section 2 to the effect that historical cost does not provide useful information on the cost of services, if price changes are significant.

Alternatively, members are requested to **provide** a rationale for why a measurement of cost that does not reflect the value foregone provides useful information on cost.

Members are also requested to **provide** further directions to assist in the improvement of the discussion of historical cost.

Current Exchange Value

20. As noted above, the Exposure Draft uses the term “current exchange value” in place of “market value,” which was used in CF–CP3.
21. As is explained in the Basis for Conclusions, this change has been made primarily for clarity: the term “current exchange value” captures more closely the intended sense. In particular it is consistent with discussing the concept even where there is little or no market for the asset. Additionally it avoids confusion with other contexts in which the term “market value” is defined, for example in International Valuation Standards.

Action Requested:

Members are requested to **confirm** that they are content with the change in terminology from “market value” to “current exchange value.”

Members are also requested to **provide** further directions to assist in the improvement of the discussion of current exchange value.

Fair Value

22. It seems necessary to depart from the order of the Exposure Draft to turn to the discussion of fair value, which is given in the Basis for Conclusions, at paragraphs BC21–BC26.
23. The concept of the fair value that is discussed here is that set out in IFRS 13, *Fair Value Measurement*.
24. This discussion concludes that fair value is unlikely to be relevant in the public sector. However, it is important in this connection that the Basis for Conclusions (in paragraph BC11) explains that the use of proxy values may, in some circumstances, be consistent with rather than a departure from the Framework.
25. The discussion on fair value has been placed in the Basis for Conclusions mainly because it seems odd for the Exposure Draft itself to discuss a measurement basis that it does not suggest will ever be the most appropriate to select. It may also be recalled that no major standard setter has ever formally set out the reasons for fair value in a conceptual document.

Action Requested:

Members are requested to **confirm** that they are content with the placing of the discussion of “fair value” in the Basis for Conclusions.

Members are also requested to **provide** further directions to assist in the improvement of the discussion of fair value.

Net Selling Price, Replacement Cost, Value in Use

26. There may well be some controversial points in the discussion in the draft Exposure Draft on the remaining measurement bases: however, staff is unable to identify them. Much of the material has been sourced from CF–CP3.

Action Requested:

Members are **requested** to **provide** further directions to assist in the improvement of the discussion of net selling price.

Members are also requested to **provide** further directions to assist in the improvement of the discussion of replacement cost.

Members are also requested to **provide** further directions to assist in the improvement of the discussion of value in use.

Boxed Text on Application of Each Measurement Basis

27. Staff were concerned in the process of drafting that the discussion was necessarily rather theoretical and arid. To assist in clarifying things, for each of the measurement bases a box headed “Application of [measurement basis]” provides:
- (a) A very short explanation of the circumstances in which the measurement basis might be selected; and
 - (b) An example or two of specific cases where it might be used.
28. The boxes were intended merely as an explanatory aid, initially for the TBG. However, TBG members commented that they were useful. They have therefore been retained in the draft Exposure Draft at this stage.
29. That said, it seems slightly odd for a Conceptual Framework to contain such specific examples. They might, of course, be placed elsewhere, such as in a non-authoritative summary.

Action Requested:

Members are requested to **provide** their views as to whether the “Application of [measurement basis]” boxes should be retained, and as to where they are most appropriately placed.

Members are also requested to **provide** further directions to assist in the improvement of the “Application of [measurement basis]” boxes.

Liabilities

30. The final section of the draft Exposure Draft addresses the measurement bases for liabilities. The discussion aims to stress the similarity of the principles to those that have been used for assets. To

the extent the considerations that apply are the same, this is stated rather than repeated. Such repetition would add considerably to the length of the document and appears to be unnecessary.

Action Requested:

Members are requested to **provide** directions to assist in the improvement of the discussion of liabilities.

Basis for Conclusions

31. The Basis for Conclusions is arranged under the following headings:

- The approach adopted in this Chapter;
- A small number of measurement bases;
- Use of proxy measurement bases;
- Initial and subsequent recognition;
- Historical cost;
- Current exchange value;
- Fair value;
- Replacement cost, net selling price and value in use;
- Liabilities; and
- Other issues.

Initial and Subsequent Recognition

32. The section on “Initial and Subsequent Recognition” has been added at the suggestion of a TBG member. It clarifies that the discussion in the Chapter is equally applicable to initial and subsequent recognition.

Other Issues

33. The section entitled “Other Issues” discusses two specific points—own credit risk and assets that are not restricted in use and may be sold for an alternative use. These issues were the subject of specific SMCs in CF–CP3. The Basis for Conclusions states that IPSASB agrees with respondents that these are standards-level issues.

Action Requested:

Members are requested to **provide** directions to assist in the further development of the Basis for Conclusions.

**CONCEPTUAL FRAMEWORK FOR GENERAL PURPOSE FINANCIAL
REPORTING BY PUBLIC SECTOR ENTITIES:**

**MEASUREMENT OF ASSETS AND LIABILITIES IN FINANCIAL
STATEMENTS**

DRAFT EXPOSURE DRAFT

1 The Role of Measurement in the Framework

- 1.1 Accounting standards need to specify the assets and liabilities that are recognized in financial statements and how they are measured. This chapter provides guidance on the selection of a measurement basis that may be used in developing International Public Sector Accounting Standards (IPSASs) and by preparers of general purpose financial statements in selecting measurement bases for assets and liabilities where there are no requirements in IPSASs. The Chapter is concerned solely with the measurement bases that may be used in general purpose financial statements, and not in other statements that may be form part of general purpose financial reporting.
- 1.2 The amount at which assets and liabilities are stated affects the amount of expenses and revenue that are reported in respect of changes in assets and liabilities. Therefore the selection of a measurement basis is important not only for the statement of financial position but also for the reporting of revenue and expenses.

Staff Note: This paragraph may require revision if deferred inflows and outflows are defined as separate elements as proposed currently in Agenda Item 4A.

- 1.3 Chapter 2 of the Conceptual Framework states “The objectives of financial reporting by public sector entities are to provide information about the entity that is useful to users of GPFs for accountability purposes and for decision-making purposes.” It identifies a number of specific information needs of service recipients and resource providers and their representatives. The selection of a measurement basis may be expected to be particularly relevant to the following:
- (a) Liquidity and solvency;
 - (b) Financial capacity—the capacity of the entity to continue to fund its activities and meet its operational objectives in the future;
 - (c) Operational capacity—the physical and other resources available to support the provision of services in future periods;
 - (d) The capacity of the entity to adapt to changing circumstances;
 - (e) The cost of services provided in the period;
 - (f) Whether current levels of taxes and other income are sufficient to maintain the volume and quality of services currently provided; and
 - (g) Whether resources have been used economically and efficiently.
- 1.4 It follows that a measurement basis will contribute to meeting the information needs of users for accountability and decision-making purposes if it provides information on the following:
- (a) The cost of services provided in the period, and in particular:
 - An appropriate comparison with the amount of taxes and other income received in the period; and
 - Whether resources have been used economically and efficiently.
 - (b) Operational capacity: the resources available to provide services in future periods.

- (c) Financial capacity: the capacity of the entity to continue to fund its activities, and meet financial claims on its resources; and financial flexibility: the capacity of the entity to adapt to changing circumstances.

The relevance of a measurement basis may be assessed by considering the extent to which it provides information on the above factors.

- 1.5 In addition to relevance, Section 3 of the Conceptual Framework identifies the qualitative characteristics (QCs) of information included in GPFRs of public sector entities as: faithful representation; relevance; understandability; timeliness; comparability; and verifiability. It notes the pervasive constraints on information included in GPFRs of materiality, cost-benefit, and achieving an appropriate balance between the QCs.
- 1.6 The extent to which information prepared on a particular measurement basis exhibits the QCs other than relevance will depend to a great extent on complexity and subjectivity. Complexity and subjectivity increase the risk of error, so to the extent that a measurement basis requires complex and subjective calculations, it will be less verifiable and less representationally faithful. Greater complexity reduces understandability and increases the burden of preparation, and so adds to cost and prejudices timeliness. Subjectivity may impair comparability between entities as different judgments may result in similar assets and liabilities being stated at different amounts. Subjectivity also impairs understandability, as the user may not have full information on the factors that have been reflected in the reported amounts.
- 1.7 It is not possible to select a single measurement basis for financial statements that will maximize the extent to which they meet the objectives of financial reporting and fulfill the QCs. This chapter does not therefore seek to prescribe a single measurement basis (or combination of bases) but rather to identify the factors that are relevant in selecting a measurement basis for particular assets and liabilities in specific circumstances.
- 1.8 A number of possible measurement bases are discussed below. They are:
- Historical cost (Section 2);
 - Current exchange value (Section 3);
 - Net selling price (Section 4);
 - Replacement cost (Section 5); and
 - Value in use (Section 6).
- 1.9 For each basis, the discussion initially addresses the extent to which the basis can provide relevant information on the items identified in paragraph 1.4 above. The discussion then addresses the extent to which the measurement basis provides information that meets the QCs and in particular whether it is likely to be complex and subjective or simple and objective.
- 1.10 The principles that apply to the measurement of liabilities are the same as those that apply to assets. However, the significance of certain issues differs, and the terminology that is appropriate for assets needs to be adapted. To increase understandability, the various measurement bases are discussed in detail in relation to assets. A final section addresses how the same bases may be applied to liabilities.

2 Historical Cost

- 2.1 Under the historical cost basis, assets are reported at the cost incurred on their acquisition, including transaction costs.
- 2.2 From a conceptual point of view, the main distinguishing feature of historical cost is that the measurement of an asset is not changed to reflect changes in prices or other economic conditions.
- 2.3 Under the historical cost basis, the amount of an asset is reduced by recognizing depreciation (or amortization) and impairment. These techniques determine the extent to which the asset has been consumed or lost, and the cost of its remaining service potential or economic benefits. Similarly the amount of an asset may be increased to reflect the cost of additions or other circumstances, such as the accrual of interest on a financial asset.

Relevance of Historical Cost

Costs of Services

- 2.4 Where a historical cost basis is used, the cost of services reflects the amount of cash expended to acquire assets consumed in the provision of services. Thus historical cost provides a direct link to the transactions actually undertaken by the entity. However, because the costs used are those carried forward from an earlier period without adjustment for price changes, they do not reflect value of assets either at the reporting date or at the time at which they are consumed. As the cost of services is reported at prices prevailing in the past, information prepared on a historical cost basis will not be the most helpful basis for assessing the likely future cost of providing services if price changes are significant. The costs of assets to be acquired in the future are more likely to be similar to those of recent purchases rather than those that were made in the more distant (and generally undisclosed) past. Furthermore, because historical cost does not reflect the value of assets at the time they are consumed, it is not possible to judge whether resources have been used economically and efficiently if price changes are significant. Even where general prices are relatively stable, the prices applicable to specific assets may change significantly.
- 2.5 Comparing the cost of services quantified at historical terms with taxes and other income in the period may also be misleading where price changes are significant as the latter are generally transactions of the current period and measured in current prices.

Operating Capacity

- 2.6 The historical cost basis provides information on the resources available to provide services in future periods, based on their acquisition cost. It may be reasoned that, at the time an asset is purchased, its value to the entity is presumably at least as great as the cost of purchase. As noted above, depreciation is recognized to reflect the extent to which the service potential or economic benefits of the asset have been consumed, and the carrying amount is also reduced to reflect impairment. If these techniques are effective, it can be expected that historical cost information will ensure that the resources available for future services are at least as valuable as the amount at which they are stated. However, under the historical cost basis increases in value are not reflected. It is therefore not possible to judge on the basis of historical cost information the extent to which the value of resources available to provide future services is in excess of the reported amount.

Financial Capacity and Financial Flexibility

- 2.7 The amount at which assets are stated in financial statements assists in an assessment of financial capacity by providing information on the amount of assets that may be used as security for borrowings. Effective security depends on the ability of the lender to realize value through sale of the asset. An assessment of financial flexibility also requires information on the amount that could be received on sale of an asset, and reinvested in assets to provide different services. Historical cost does not provide this information. Hence when historical cost is used in the financial statements there is a case for supplementary disclosure of selling prices.

Complexity, Subjectivity and the Qualitative Characteristics

- 2.8 Application of historical cost often involves little complexity and subjectivity. As a result amounts derived on a historical cost basis are generally representationally faithful in that they reliably represent what they purport to represent—that is, the historical cost of the asset—and are verifiable, understandable and can be prepared on a timely basis.
- 2.9 Although the simplicity and objectivity of historical cost contribute towards comparability, information prepared on that basis is comparable only to the extent that prices prevailing at the time of acquisition are similar. Because historical cost does not reflect the impact of price changes, it is not possible to compare the amounts of assets that were acquired at different times when prices prevailing were different. This difficulty arises when comparing the financial statements of entities that hold or consume assets acquired at different times as well as within the financial statements of a single entity.
- 2.10 In some circumstances, however, complexity and subjectivity arise even in the application of historical cost. In some circumstances it is necessary to use allocations, for example: where several assets are acquired in a single transaction; where assets are constructed by the entity itself and overheads and other costs have to be allocated; and, where many similar assets are held, the use of a flow assumption, such as first-in-first-out (“FIFO “). To the extent such allocations are subjective or arbitrary they lessen the extent to which the resulting measurement fulfills the QCs.

Application of Historical Cost

Historical cost is an appropriate measurement basis for many assets held for use in an entity's operations, especially where price changes are unlikely to be significant during the period for which the asset is held by the entity.

Examples: some inventories that are consumed within a short time of purchase; items of property, plant and equipment that have short lives, such as motor cars and computer equipment.

3 Current Exchange Value

- 3.1 A “current exchange value” represents the amount at which an asset could be exchanged in an arm’s length transaction between willing parties. It is defined as:
- “The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction at the reporting date.”
- 3.2 It is implicit in the definition that there is no significant difference between an asset’s exit value (the amount that the entity would receive on its sale) and its entry value (the cost to the entity of purchasing the asset).
- 3.3 The premise that exit and entry values are generally the same may be questioned. An entity typically purchases goods from vendors such as distributors and manufacturers that are in the business of selling the relevant type of goods. The entity that uses the asset is not usually also in the business of selling them and therefore cannot expect to achieve as large a price as the vendor charges. One reason for that is that any purchaser will prefer to purchase goods from a specialist vendor because they can rely on the vendor’s reputation.
- 3.4 The *Key Characteristics of the Public Sector with a Potential Impact on Financial Reporting* document (*Key Characteristics*) notes that public sector entities necessarily hold specialized assets in order to provide services. The premise that entry and exit values are the same is especially questionable in such circumstances.
- 3.5 Current exchange values may however be used where it is judged that the difference between entry and exit values is unlikely to be significant.

Relevance of Current Exchange Values

- 3.6 It can be reasoned that, in principle, current exchange values provide relevant information because they fairly reflect the value of the asset to the entity. The asset cannot be worth less, as the entity can obtain that amount by selling the asset, and cannot be worth more, as the entity can obtain equivalent utility by purchasing the asset.
- 3.7 This, however, relies on the assumption that the asset may be purchased or sold at the current exchange value. As noted above, it is questionable whether an entity can usually sell an asset for the same price at which it the asset is acquired. Furthermore, the purchase of an asset provides evidence that the value of the asset to the entity is at least as great as its purchase price, but it may be more. Hence current exchange values do not reflect the value to the entity.

Costs of Services

- 3.8 If assets used to provide service are measured at current exchange value, revenue reflecting price changes will be recognized over the period during which the asset is held. At the time the asset is consumed, the reported cost will be the current exchange value of the asset. It may be argued that this provides a valid basis for comparison with the taxes and other revenue received in the period, which are also generally measured at current values.
- 3.9 If current exchange prices are used, it is helpful to present the expense relating to the consumption of the asset in the provision of services separately from changes relating to price changes.

Staff Note: This paragraph may require revision if deferred inflows and outflows are defined as separate elements.

- 3.10 It can be argued that the use of current exchange values permits the comparison of the amount received on sale of an asset with its current exchange value, and thus shows the extent to which the entity has obtained a superior return to that which is implicit in current market prices. However, this seems less convincing in relation to the public sector. Public sector activities are not generally carried out with the primary objective of generating profits, and services are often for free or on subsidized terms so there is little relevance in comparing the reported return to that implicit in market prices.
- 3.11 Some may object to the use of current exchange values for reporting the cost of services because it does not, in their view, faithfully report the transactions actually undertaken by the entity. As noted above, that information is reported by historical cost. Information based on current values shows the cost as being that which would apply if the assets were purchased at the time the service was provided.
- 3.12 As noted above, if current exchange values are used as a measurement basis, revenue reflecting price changes will be recognized over the period during which the asset is held. Thus the surplus or deficit for a period reflects price movements that take place over the period during which assets and liabilities are held, and no revenue or expense is reported on the sale of an asset. Where the asset is traded on an active and liquid market, this may be seen as an advantage as the existence of the market assures that the entity is able to realize the market value (and no more) at the reporting date: it is therefore unnecessary and potentially misleading to postpone recognition until a profit is “realized” on sale. However, many assets used to provide services are not traded on such markets and in such cases the relevance of such income and expenses is doubtful.

Operating Capacity

- 3.13 Information on the current exchange value of assets held to provide services in future periods is useful if it reflects the value that the entity is capable of deriving from the asset by using them in providing or delivering services. It is not useful, however, if assets that are most efficiently used to provide services have been written down to a selling price.

Financial Capacity and Financial Flexibility

- 3.14 As noted above, an assessment of financial capacity and financial flexibility requires information on the amount that would be received on sale of an asset. Although in principle this information is provided by the current exchange value basis, it will not do so where the difference between exit and entry values is significant, unless “current exchange value” is interpreted as requiring an exit price.

Complexity, Subjectivity and the Qualitative Characteristics

- 3.15 The usefulness of current exchange values varies depending on the quality of the market evidence. This, in turn, depends upon the characteristics of the market in which the asset is traded.
- 3.16 The following paragraphs discuss three kinds of current exchange values that differ depending on the quality of the market evidence:

- Ideal market values;
- Estimated market values; and
- Notional market values.

3.17 The distinction between these three kinds of value is not always clear-cut. The aim is to highlight some of the issues that are relevant to whether the use of a current exchange value should be required in a particular case. Examples are intended to assist understanding and are illustrative only.

Ideal Market Values

3.18 In the ideal situation markets are deep and liquid with many well-informed buyers and sellers. Such markets deal in assets that are fungible¹, such as commodities, currencies and securities and prices are publicly available. In practice few, if any, markets fully exhibit all of these characteristics but some may approach the ideal. Markets for assets that are unique and rarely traded fall at the other extreme: any purchases and sales are individually negotiated, and there is a large range of prices at which a transaction might be agreed.

3.19 In these circumstances, the market values can be readily used for financial reporting purposes. There is little or no complexity or subjectivity, and the information will exhibit the qualitative characteristics: that is it will be relevant, representationally faithful, understandable, comparable and verifiable. Because it can be prepared quickly, such information is also likely to be timely. However, the extent to which the information reflecting current exchange values has the QCs will decrease as the quality of market evidence decreases.

3.20 Information based on market values can be expected to be highly comparable, both within and between entities, as similar assets will be stated at similar amounts.

Estimated Market Values

3.21 Markets for some assets—for example, some securities, commodities and currencies—approach the ideal position discussed above. It is also possible to use estimated market values for financial statements where market prices for similar, but not identical, assets are available. For example, an unquoted investment might be valued by reference to prices for similar quoted investments, adjusted to reflect any relevant differences, such as the lower liquidity associated with an unquoted investment. Where such estimated market prices are used, the extent to which the information exhibits the qualitative characteristics will be reduced, but the use of such prices may have the advantage of consistency of treatment of similar assets (e.g., quoted and unquoted investments).

3.22 Adjustments to market prices introduce complexity and subjectivity and so reduce representational faithfulness (which includes reliability) comparability and verifiability. This is particularly the case where estimated market value can only be derived from models. This also diminishes understandability as the user of the information may not appreciate the limitations of the models used to derive estimated values and the assumptions on which they rely. For example, it may not always be understood that, although a value has been adjusted to take into account the lack of liquidity of an asset, it cannot be assumed that the asset can readily be liquidated at the stated amount: a forced sale value would be lower.

¹ Assets are fungible when they are identical and so mutually interchangeable.

Notional Market Values

- 3.23 In some circumstances there is little information on the current exchange value of an asset. This is often the case in the public sector where assets that are held to provide services that would have little or no value to another party without significant adaptation for their different operational requirements.
- 3.24 A realistic appraisal of the current exchange value of such an asset would usually attribute a low value to it. This is because any prospective purchaser would have to bear the cost of adapting the asset to an alternative use. A prison, for example, might be constructed at a considerable cost but a valuation would reflect only the value of the land and, unless the building could be adapted to an alternative use, be reduced by the cost of demolition. Reporting such an asset at that low value would not be relevant, as the entity is unlikely to dispose of an asset that it requires in order to fulfill its service objectives. Nor would such a value be representationally faithful of the value of the asset to the public sector entity, which can obtain the services provided by the asset only by incurring a cost that is greater than that value, as such an asset will rarely if ever be available on the market. Furthermore, reducing the carrying value of a newly constructed asset to its market price would result in a reported loss, which would not provide representationally faithful information on the financial performance of the entity.
- 3.25 It is possible to prescribe that, for such assets, the relevant market value is that which would be obtained in the case of a sale to a purchaser who can use the asset in the same manner as the current owner and, for example, owns any complementary assets. However, imagining a market participant that has the same opportunities as the reporting entity seems to be highly hypothetical, as many of the assets used by public sector entities in providing services would not be used by other entities. Thus this approach seems to lack relevance.

Application of Current Exchange Value

Current exchange value is an appropriate measurement basis for assets that are quoted on a deep and liquid market, and that may be disposed of without affecting the operations of the entity.

Examples: quoted securities, investment properties.

4 Net Selling Price

4.1 “Net selling price” is defined as:

“The amount that the entity can obtain from sale of the asset at the reporting date, after deducting the costs of disposal.”²

4.2 Net selling price differs from current exchange value in that it is explicit that it is a selling price—an exit value—and that it is reduced by transaction costs, the costs of disposal.

Relevance of Net Selling Price

4.3 The potential relevance of net selling price is clear, in that an asset cannot be worth *less* to the reporting entity than the amount it could obtain on sale of the asset. However, it will not be relevant if the entity is able to make a more efficient use of its resources by employing the asset in another way, for example using it in the delivery of services.

4.4 Net selling price is, however, clearly relevant where the most resource-efficient course available to the entity is to sell the asset. This is the case where the asset cannot deliver service potential or economic benefits at least as valuable as net selling price. Net selling price is not, however, the most relevant measurement basis for an asset simply because management intend to dispose of an asset.

Costs of Services

4.5 It would not be relevant to quantify the cost of the provision of services at net selling prices. This would imply that assets were written down to net selling price at the time of acquisition and that the expense reported when they were consumed in the provision of services would be based on that reduced amount.

Operating Capacity

4.6 It would also not generally provide information useful to an assessment of operating capacity to state assets held for use in the provision of services at net selling price. This would show the amount that could be derived from their sale, rather than the value of the service potential or economic benefits that could be derived from the asset.

Financial Capacity and Financial Flexibility

4.7 As noted above, an assessment of financial capacity and financial flexibility requires information on the amount that would be received on sale of an asset. This is the information provided by the use of net selling price. However, the lack of relevance for net selling price for assets that may yield more valuable services suggests that this information may be better presented as supplementary information rather than used in the statement of financial position, except for assets whose most resource-efficient use is to be sold.

Complexity, Subjectivity and the Qualitative Characteristics

4.8 Assessments of net selling price may be subjective, but will often not be highly complex. For major assets it may be possible and cost-effective to obtain professional appraisals. For other assets, it

² “Net selling price” is similar to the concept of “fair value less costs to sell” used in IPSASs.

may be clear that net selling price is so low that it will not be materially different from a nominal amount or nil.

- 4.9 It would seem likely that in most cases where net selling price is relevant, it will be adequately representationally faithful, verifiable and capable of being produced in timely manner. It will also generally be understandable and comparable.

Application of Net Selling Price

Net selling price is an appropriate measurement basis only for assets that are not capable of yielding service potential or economic benefits if they continue to be held and therefore can only be sold.

Examples: plant that has reached the end of its useful life; obsolete buildings that cannot be used by the entity. Inventory that is in excess of the needs of the entity.

5 Replacement Cost

5.1 The replacement cost of an asset is:

“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.”

5.2 Replacement cost differs from a current exchange price in the following ways:

- (a) It is explicitly an entry value;
- (b) It includes all the costs, including transaction costs, that would necessarily be incurred in the replacement of the service potential of an asset; and
- (c) It reflects the economic position of the entity rather than the position prevailing on a hypothetical market. For example, the replacement cost of a vehicle would be less for an entity that usually acquires a large number 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.

5.3 Because entities usually acquire their assets by the most economic means available, replacement cost reflects the procurement process that an entity generally follows. The concept of replacement cost is that of replacement in the ordinary course of operations, and not the costs that might be incurred if an urgent necessity arose as a result of some unforeseeable event (such as a fire).

5.4 It is important to distinguish replacement cost, which is the cost of replacing an asset's service potential, from reproduction cost, which is the cost of acquiring an identical asset. Although in many cases the most economic replacement of the service potential will be by purchasing an asset that is similar to that which is owned, replacement cost would be based on that of the alternative asset if it would provide the same service potential more cheaply. It is necessary to make adjustments to reflect differences between the existing and the replacement asset, for example by deducting depreciation to reflect the extent to which the service potential of the existing asset has been consumed.

5.5 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 an entity owns a school that is adequate for 500 pupils but, perhaps because of demographic changes since its construction, 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.

Relevance of Replacement Cost

5.6 The major advantage of replacement cost compared to other measurement bases is its relevance for both accountability and decision-making purposes. Because it is a current value, replacement cost reflects economic conditions prevailing at the 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 is reflected in its carrying amount, and does not vary according to the value—or, in the case of specialized assets, lack of value—that the asset may have to another entity.

- 5.7 In many cases the value of future services that will be derived from an asset will be greater than its replacement cost. However, it would not be relevant to report the asset at the value of those services, as they are future benefits rather than the benefit of ownership that is present at the reporting date. Replacement cost represents the highest relevant value of an asset, as, by definition, the entity is able to secure equivalent service potential by incurring replacement cost.

Costs of Services

- 5.8 Replacement cost may be reasoned to provide a relevant measure of the cost of the provision of services. The cost of consuming an asset is equivalent to the amount of the sacrifice incurred by that use. The loss incurred by using an asset is its replacement cost: the entity is able (if it is so desired) to restore its position to that prevailing immediately before the consumption of the asset by an outlay equal to replacement cost. Put another way, the economic decrement caused by consumption of an asset is its replacement cost.
- 5.9 Where replacement cost is used to report the cost of services, they are reported in current terms. Thus the amount of assets consumed is stated at their value at the time they are consumed (and not, as with historical cost, at the time they were acquired). This may provide a useful basis for an assessment of the cost of providing services in the future and future resource needs, as future costs are more likely to resemble current costs than those incurred in the past, when prices were different. It also provides a valid basis for an appropriate comparison between the cost of services and the amount of taxes and other income received in the period (which are generally transactions of the current period and measured in current prices), and for assessing whether resources have been used economically and efficiently.
- 5.10 In order to show the current cost of consumption, it is helpful to distinguish that cost from changes in the amount of assets that relate to price changes.
- 5.11 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 “realized holding gains.” This permits the financial statements to report both (a) the costs based on actual transactions, which may be useful for an assessment of accountability, as well as (b) the costs based on current prices, which is useful to an assessment of future resource needs.

Operating Capacity

- 5.12 In principle, replacement cost provides a useful measure of the resources available to provide services in future periods, as it is focused on the current value of assets and their service potential to the entity.

Financial Capacity and Financial Flexibility

- 5.13 As noted above, an assessment of financial capacity and financial flexibility requires information on the amount that would be received on sale of an asset. Replacement cost does not provide this information. Thus where it is used as a primary basis of financial reporting, it may usefully be supplemented by information on another basis, such as net selling price.

Complexity, Subjectivity and the Qualitative Characteristics

- 5.14 In some cases calculation of replacement cost will be complex, and subjective judgments will be required. This makes the measurement of replacement cost less reliable, and hence less representationally faithful. Such cases also prejudice the timeliness, comparability and verifiability of information prepared on a replacement cost basis, and will also make it more costly than some alternatives.
- 4.10 Replacement cost information may be expected to be comparable within an entity as assets that offer equivalent service potential will be stated at similar amounts. In principle different entities may report similar assets at different amounts, because replacement cost reflects the opportunities for replacement that are available to the entity. It would appear, however, that the opportunities for replacement would usually be the same for different public-sector entities. Where they are different, however, it can be argued that the entity that is able to acquire assets more cheaply has an economic advantage that, in order to be representationally faithful should be reported in financial statements through a lower cost of services and lower asset values.

Application of Replacement Cost

Replacement cost is an appropriate measurement basis only for assets that will be used in the provision of services and for which replacement cost is readily obtainable.

Examples: buildings such as prisons, schools and hospitals. Inventories such as commodities that are subject to significant price changes during the period for which they are held.

6 Value in Use

6.1 Value in use is defined as:

“The present value at the reporting date to the entity of the asset’s remaining service potential or economic benefits if it continues to be used, and of the net amount that the entity will receive from its disposal at the end of its useful life.”

Relevance of Value in Use

- 6.2 As noted in paragraph 5.7 above, the value of an asset’s service potential is often greater than its replacement cost. (It is also usually greater than its historical cost). Where this is the case, reporting an asset at its value in use would have little relevance, as it represents future benefits rather than the benefit of ownership at the reporting date. By definition, the entity is able to secure equivalent service potential at replacement cost.
- 6.3 For this reason, value in use is mainly used for impaired assets, that is, assets where the amount of the remaining service potential or economic benefits is less than the carrying amount, which reflects historical cost or replacement cost. An alternative approach in such cases is to revise the estimate of the asset’s remaining service potential or economic benefits and hence its replacement cost.
- 6.4 Value in use is also not a relevant measurement basis when net selling price is greater than value in use, as in this case the most resource-efficient use of the asset is to sell it, rather than continue to use it.
- 6.5 Thus value in use is only relevant where it is less than replacement cost and greater than net selling price. In such circumstances it can be reasoned to represent the value of the asset to the entity.
- 6.6 Because value in use has a role in financial reporting only in conjunction with other measurement bases, there is no benefit in assessing the relevance of information prepared wholly on the basis for value in use for specific purposes.

Complexity, Subjectivity and the Qualitative Characteristics

- 6.7 In some cases, an asset’s value in use can be quantified by calculating the value that the entity will derive from the asset assuming its continued use. This may be based on the future cash inflows, or on cost savings that will accrue to the entity through its ownership of the asset. The calculation of value in use should take account the time value of money and, in principle, the risk of variations in the amount and timing of cash flows.
- 6.8 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 then allocating, inevitably with some arbitrariness, the total to individual assets.
- 6.9 In the public sector, most assets contribute to the provision of subsidized or uncharged services rather than to the generation of net cash flows: such assets are referred to as “non-cash-generating assets.” It may be particularly difficult to calculate value in use for such assets.
- 6.10 It will be apparent that calculation of value in use is complex and subjective, even in relatively straightforward cases. This complexity and subjectivity impairs the reliability of value in use, and

hence make value in use less representationally faithful. It also prejudices the timeliness, comparability and verifiability of information prepared on a value in use basis.

Application of Value in Use

Value in use is an appropriate measurement basis for assets that will continue to yield service potential but which would not merit replacement. These are generally assets that would not recover their carrying amount unless written down to value in use.

Examples: assets where the service potential has been impaired due to price changes or decrease in demand for its services. Assets that continue to provide cost savings, would command only a negligible value if sold and cannot be replaced.

7 Measurement Bases for Liabilities

- 7.1 This section reviews the measurement bases discussed in the earlier sections of this Chapter in the context of liabilities. As stated in paragraph 1.10, the principles that apply to the measurement of liabilities are the same as those that apply to assets. However, the significance of certain issues differs, and the terminology that is appropriate for assets needs to be adapted.
- 7.2 The measurement bases for assets, and the corresponding terminology for liabilities is set out below:

Assets	Liabilities
Historical cost	Historical cost
Current exchange value	Current exchange value
Net selling price	Cost of release
Replacement cost	Assumption price
Value in use	Cost of fulfillment

Historical Cost

- 7.3 Under the historical cost measurement basis, liabilities are stated at the value of the amount received in the transaction under which the obligation is assumed.
- 7.4 Where the time value of a liability is material (that is, where the length of time before payment falls due is significant), the amount of the future payment is discounted so that, at the time a liability is first recognized, it represents the value of the amount received. The discount is amortized over the life of the liability, with the result that the liability is stated at the amount of the required payment when it falls due.
- 7.5 The advantages and drawbacks of using the historical cost basis for liabilities are similar to those that apply in relation to assets. However, it cannot be applied for liabilities that do not arise from a transaction, such as a liability to pay damages for a tort. It is also difficult to apply historical cost to liabilities that may vary in amount, such as many defined benefit pension liabilities.

Current Exchange Value

- 7.6 Conceptually, the advantages and disadvantages of a current exchange value for liabilities are the same as those for assets. Such a measurement basis may be appropriate, for example, for liabilities under derivative financial contracts that are traded on organized exchanges. However, in many cases, the ability to transfer a liability is restricted and the terms on which such a transfer might be made are unclear: in such circumstances the case for current exchange values is significantly weaker.
- 7.7 Where a market value is used to measure a liability it is necessary to consider the treatment of the entity's own credit risk. This is not addressed in this Chapter.

Cost of Release

- 7.8 Like net selling price, cost of release refers to the amount that would be relevant for an immediate exit. In the case of a liability, that is the amount that would be paid. Cost of release is the amount that either (a) the creditor will accept in settlement of its claim; or (b) a third party would charge to accept the transfer of the liability. Where there is more than one way of securing release from the

liability, the cost of release is that of the lowest amount. (Similarly for assets, net selling price would not reflect the amount that would be received on sale to a scrap dealer, if a higher price could be obtained from sale to a buyer who would use the asset.)

- 7.9 For many liabilities, particularly in the public sector, it will be clear that transfer is not practically possible and cost of release will therefore be simply the amount that the creditor will accept in settlement of its claim. This amount will be known if it is specified in the agreement with the creditor (for example, where a contract includes a specific cancellation clause).
- 7.10 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). Transferring a liability may be distinguished from entering into an agreement with another party that will fulfill the entity's obligation or bear all the costs stemming from a liability. For a liability to be transferred it is necessary that all of the creditor's rights against the entity are extinguished. If this is not the effect of an arrangement, the liability continues to exist and should continue to be reported. The arrangement may, however, result in a separate asset of the entity that represents 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 a transfer of the liability (unless the lessor agrees to release the liability and obtains rights directly against the contractor).
- 7.11 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, having regard to any consequences of obtaining release, such as damage to the entity's reputation.
- 7.12 Just as net selling price is relevant only when the most resource-efficient course available to the entity is to sell the asset, so cost of release is relevant only when the most resource-efficient course is to seek immediate release from an obligation. In particular, where cost of fulfillment is lower than cost of release, cost of fulfillment will be more relevant than cost of release.

Assumption Price

- 7.13 "Assumption price" is the term used in the context of liabilities to refer to the same concept as "replacement cost" in the context of assets. Just as replacement cost represents the amount that an entity would rationally pay to acquire an asset, so assumption price is the amount which the entity would rationally be willing to accept in exchange for assuming a liability. Assumption price is most often relevant to exchange transactions carried out on arms-length terms, rather than non-exchange transactions.
- 7.14 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 fulfillment or release (i.e., settlement amount). Once that amount has been paid, the entity has an obligation to its creditor.
- 7.15 Although typically the entity will expect to be able to fulfill its obligation and thereby extinguish its liability, it is an oversimplification to characterize the obligation as simply that of performing. More precisely, the entity's obligation is *either* to perform *or* to compensate the other party for any loss that might arise from the entity's failure to perform. Compensation would at least include refunding the amount paid. Thus stating the liability at assumption price provides a representationally faithful measure, reflecting the entity's accountability to its creditor for the amount that has been paid.

- 7.16 At the time a liability is first incurred, assumption price represents the amount that was accepted by the entity for assuming the liability: it is therefore usually reasonable to assume that it is the price that it would rationally accept for assuming a similar liability. It would charge a higher amount, if competitive pressures allowed it to do so, but it might be unwilling to accept a lower price. Just as replacement cost is a current value so, conceptually, is assumption price. There are, however, serious practical problems in reflecting changes in prices in obligations that are stated at assumption price.
- 7.17 It is sometimes questioned whether items reported as “deferred outflows” are liabilities. It is possible that some such items can be seen as performance obligations that are measured at assumption price.

Staff Note: This paragraph may require revision if deferred inflows and outflows are defined as separate elements as proposed in Agenda Item 4A.

- 7.18 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 fulfillment (or release), as it is the difference between the revenue arising from satisfaction of the liability and the cost of settlement.
- 7.19 An entity may have a potential obligation to its customer that is larger than assumption price. If the entity has to seek 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 fulfillment, it can avoid such additional obligations and it is representationally faithful to report the obligation at no more than assumption price. (This is analogous to the position where an asset will yield greater benefits than replacement cost where, as explained above replacement cost rather than value in use is the most relevant basis).

Cost of Fulfillment

- 7.20 Just as value in use refers to the value that will generally be derived from future use of an asset, cost of fulfillment refers to the burden of what will usually happen in practice. It is the current value of fulfilling the obligations represented by the liability. Where the obligation is financial, fulfillment will be making the required payments; where the obligation is to provide goods or services, fulfillment consists of providing those goods or services.
- 7.21 The cost of fulfillment 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.
- 7.22 Where the cost of fulfillment depends on uncertain future events, all possible outcomes are reflected in the estimated cost of fulfillment, which should aim to reflect all those possible outcomes in an unbiased manner.
- 7.23 Where fulfillment requires work to be done—for example where the liability is to rectify 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 its behalf. However, the costs of employing a contractor are only relevant where employing a contractor is the least costly means of fulfilling the obligation.

- 7.24 The cost of fulfilling a liability is the value to the entity of resources that will be used in making fulfillment, and not necessarily their carrying amount.
- 7.25 Where fulfillment will be made by the entity itself, the fulfillment cost does not include any profit, because any such profit does not represent a use of the entity's resources. Where fulfillment amount is based on the cost of employing a contractor, the amount will implicitly include the profit required by the contractor, as the total amount charged by the contractor will be a demand on the entity's resources. (Analogously, for assets replacement cost would include the profit required by a supplier, but no profit would be included in the replacement cost for assets that the entity would replace by its own construction efforts).
- 7.26 Where fulfillment 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.
- 7.27 Cost of fulfillment is generally relevant except in the following circumstances:
- (a) Where the entity can obtain release from an obligation at a lower amount than cost of release, then cost of release is a more relevant measure of the current burden of a liability. (Just as, for an asset, net selling price is more relevant when it is higher than value in use).
 - (b) In the case of liabilities assumed for a consideration, assumption price is more relevant when it is higher than both cost of fulfillment and cost of release.

Appendix 1A

The IASB Conceptual Framework (September 2010)

Measurement of the Elements of Financial Statements

The International Accounting Standards Board (IASB) develops and publishes International Financial Reporting Standards (IFRSs). IFRSs are designed to apply to the general purpose financial statements and other financial reporting of all profit-oriented entities.

The IASB Conceptual Framework (issued in 1989 and updated in part in September 2010) identifies the following measurement bases:

- Historical cost;
- Current cost;
- Realisable (settlement) value; and
- Present value.

It notes that the measurement basis most commonly adopted is historical cost, which is usually combined with other measurement bases.

Appendix 1B

**The Statistical Bases of Reporting of the 1993 System of National Accounts (updated 2008) and
Other Guidance derived from it (ESA 95 and GFSM 2001)**

Measurement of the Elements of Financial Statements

[Not in this draft.]

Basis for Conclusions

This Basis for Conclusions accompanies, but does not form part of, the Conceptual Framework.

The Approach Adopted in this Chapter

- BC1. In December 2010, the IPSASB published a Consultation Paper, *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: Measurement of Assets and Liabilities in Financial Statements* (CF–CP3). This Exposure Draft has been developed after fresh deliberations by the IPSASB and careful consideration of the responses received to CF–CP3.
- BC2. CF–CP3 envisaged that the Framework would not seek to identify a single measurement basis (or combination of bases) for all circumstances, but rather should discuss factors that are relevant in selecting the measurement basis to be required for particular assets and liabilities in specific circumstances. It is acknowledged that requiring a single measurement basis to be used in all circumstances would clarify the relationship between different amounts reported in the financial statement: in particular, the amounts of different assets and liabilities could be added to provide meaningful totals. However, there is no single measurement basis that will maximize the extent to which financial statements meet the objectives of financial reporting and fulfill the qualitative characteristics.
- BC3. Respondents generally supported this approach. Some respondents, while supporting the general approach, suggested that the selection of a measurement basis should be guided by a single measurement objective, such as providing the value to the entity at the reporting date. Possible objectives were considered, but this suggestion has not been pursued as it might unduly restrict the choice of measurement bases. Specifying an overall measurement objective would also run the risk that it would compete with, rather than complement, the overall objectives of financial reporting and the QCs. Accordingly, the Framework relates the factors relevant to the selection of a measurement basis to that objective and the QCs.
- BC4. The IPSASB noted that the disadvantages of the using different measurement bases may be minimized by:
- Selecting different measurement bases only where this is justified by economic circumstances, and hence ensuring that assets and liabilities are reported on the same basis where circumstances are similar; and
 - Requiring transparent presentation and disclosure to ensure that the measurement bases used and the amounts reported on each basis are clear.

A Small Number of Measurement Bases

- BC5. The Chapter aims to be complete by discussing the measurement bases that need to be considered in the selection of an accounting policy. Those that are addressed in this Chapter include those that are often used in practice or advocated in theory, with the exception of “fair value” for the reasons discussed in paragraphs BC21–BC26 below.
- BC6. CF–CP3 discussed the following measurement bases: historical cost; market values; replacement cost. In addition, value in use and net selling price were discussed in the context of the deprival value model. The same measurement bases are discussed in this Chapter. However, the term “current exchange value” has been used in place of “market value” to

increase clarity. Respondents to CF–CP3 generally agreed that these were the most relevant bases, and did not suggest further bases, other than fair value, that should be discussed. Fair value is discussed in paragraphs BC21–BC26 below.

- BC7. The Chapter aims to provide useful guidance for the selection of a measurement basis but it does not aim to be determinative. In many circumstances it will remain a matter of judgment as to which measurement basis most effectively meets the objectives of financial reporting and secures the best balance between the QCs.

Use of Proxy Measurement Bases

- BC8. There may also be cases where other measurement bases may be selected. A measurement basis may be well established for use for statistical purposes or by the valuation or actuarial profession: that basis might be selected as a proxy on the grounds of cost-benefit where it seems likely it will not usually differ materially from the measurement basis suggested by the discussion in this Chapter. The sensible use of proxies is an application of rather than a departure from the Framework.

Initial and Subsequent Recognition

- BC9. A measurement basis needs to be selected both when an asset or liability is recognized for the first time (initial recognition) and when it is reported in the financial statements of a later period (subsequent recognition). Some accounting policies are expressed in a way that may suggest that different principles apply to initial and subsequent recognition. For example, an asset may initially be recognized at transaction price and subsequently at a current value, or initially be recognized at fair value, and subsequently stated at a depreciated amount. The IPSASB therefore considered whether the Chapter should discuss initial and subsequent recognition separately.
- BC10. One reason why different measurement bases may be specified for initial and subsequent recognition is that the basis to be used for subsequent recognition is not available at the time of initial recognition. This is particularly common in the public sector where assets are sometimes contributed, or provided on subsidized terms, or in exchange for other non-cash assets. In such a case the value of the transaction may be unknown, and if the asset is to be subsequently accounted for at an entry value such as historical cost or replacement cost, another basis has to be specified for use on initial recognition as a proxy for the amount at which the asset would be stated if purchased on arm's-length terms. Proxies may also be required for the initial recognition of assets acquired before the introduction of accrual accounting where the transaction price is not known. As stated above, the sensible use of proxies is an application of a measurement basis rather than a departure from it.
- BC11. Another reason for an apparent difference in initial and subsequent recognition arises where an asset is to be accounted for at a current value, and the transaction price is deemed to reflect the particular current measurement basis that will be used. In such a case, specifying that the asset is to be initially recognised at transaction price makes it clear that that application of the policy will not result in the recognition of revenue or income on initial recognition ("day one" profits or losses). In principle, the same measurement basis is used for both initial and subsequent recognition: the requirements for each are specified differently in order to assist understanding.

BC12. The IPSASB concluded that, in principle, the same considerations apply to initial and subsequent recognition. Accordingly the discussion in this Chapter is applicable to both situations.

Historical Cost

BC13. Many respondents to CF–CP3 supported the continued widespread use of historical cost as a measurement basis, mostly in combination with other measurement bases. They supported this view by reference to the simplicity and verifiability of historical cost. Supporters of historical cost also saw value in the link to the transactions actually undertaken by the entity that is provided by historical cost, which they regarded as particularly important for an assessment of accountability. They also noted that, because historical cost is widely used under current practice, its continued use avoids the costs that would arise if a standard were to require the use of a different measurement basis.

BC14. The IPSASB agreed that historical cost is simple and verifiable and that where it is used under current practice, a change to another measurement basis should be required only where it is judged that the benefits of doing so outweigh the costs of change.

BC15. The IPSASB also agreed that, in some contexts, it is relevant to provide information on the transactions actually carried out by the entity. However, it noted this information may be provided by supplementary disclosures where a measurement basis other than historical cost is used.

BC16. Some respondents suggested that historical cost information provided a relevant basis for the reporting of the cost of services. However, the cost of providing services is the value that has been sacrificed in order to provide those services. Because historical cost does not reflect the value of assets at the time they are consumed, it does not provide information on that value. However, where the effect of price changes is not significant, historical cost may be adequate.

BC17. Some respondents agreed with the suggestion made in CF–CP3 that the use of historical cost facilitated a comparison of the actual results and the approved budget. However, although budgets may often in practice be prepared on a historical cost basis, they may also reflect anticipated price changes. Ease of comparison against budget is therefore not cited in this Chapter as an advantage of historical cost.

Current Exchange Value

BC18. CF–CP3 discussed “market values” as a possible measurement basis. The term “current exchange value” is adopted in this Chapter for clarity, and to emphasize that the discussion addresses both the circumstance where the asset in question is traded on a market and where it is not.

BC19. The definition of “current exchange value” is the same (with the addition of “at the reporting date”) to the term “fair value” as that term is used in current IPSASs.

BC20. The Chapter provides a discussion of current exchange value as it and similar concepts have been used in accounting standards and it is likely that this will continue for some time. That discussion enables similarities with and differences from other measurement bases to be

highlighted and is therefore helpful in providing a complete and unbiased discussion of measurement bases.

Fair Value

- BC21. Some respondents suggested that the Chapter should discuss the concept of fair value. Many discussions of measurement compare and contrast only historical cost and fair value: such discussions do not address the differences between different bases all of which are current values. Except for historical cost, all the measurement bases discussed in this Chapter are current values—that is, they use prices prevailing at the reporting date—and are therefore within the compass of “fair value” as it features in such discussions.
- BC22. The IASB has recently issued IFRS 13, *Fair Value Measurement*. IFRS 13 does not form part of the IASB’s work on its Conceptual Framework. Its objective is to define “fair value” as that term is used in other accounting standards and to set out a framework for measuring fair value. Although IFRS 13 should not be read as a conceptual document, it does provide an indication of a leading private sector standard setter’s thinking on “fair value.”
- BC23. IFRS 13 defines “fair value” as follows:
- “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” (paragraph 9).
- BC24. The IFRS 13 definition of fair value differs from the concept of current exchange value in that it is explicitly an exit value: it uses the price that would be received on sale of an asset. IFRS 13 is also explicit that it is the price prevailing in a transaction with another market participant that is relevant. IFRS 13 also suggests that fair value should not be adjusted to reflect transaction costs—that is, the costs that would be incurred if the asset were to be sold.
- BC25. The IPSASB concluded that fair value, as defined in IFRS 13 is unlikely to be relevant in the public sector. Many assets are specialized and differences in entry and exit prices are therefore significant. Where an asset will provide service potential or other economic benefits that are greater than its exit price, a measure reflecting exit values is not the most relevant basis. Where the most resource efficient course is to sell the asset (because the service potential or economic benefits that it will provide is not as great as can be received from sale, the most relevant measurement basis is likely to be net selling price, and this should be reduced to reflect the costs of sale.
- BC26. The IPSASB considered the argument that fair value provides a relevant basis for assessing a financial return. Where assets are stated at fair value, financial performance can be assessed against in the context of the return implicit in market values. However, public sector activities are not generally carried out with a view to obtaining a financial return, so the relevance of assessing any such return in the context of a market setting seems slight.

Replacement Cost, Net Selling Price and Value in Use

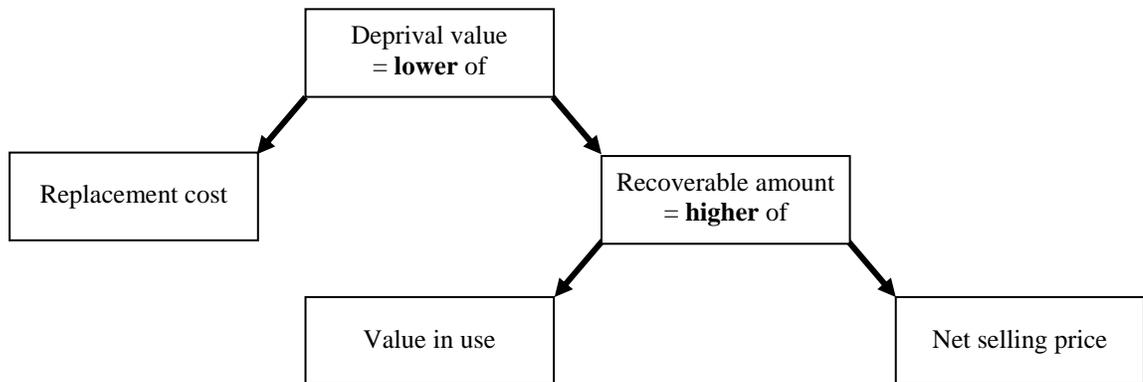
- BC27. CF–CP3 discussed the deprival value model (sometimes referred to as the “value to the entity” model). This provides a rationale for the selection of the most relevant basis in specific circumstances. The deprival value model is built on the premise that the value of an asset to an entity (that is, its deprival value) reflects the loss that the entity would sustain if it were

deprived of the asset. This may also be stated as the amount that the entity would rationally pay to acquire the asset, if it did not already own it.

BC28. The value of an asset to the entity cannot be higher than replacement cost as, by definition, the entity is capable of obtaining equivalent service potential (including the net amount that would be received on disposal) by incurring a cost equivalent to replacement cost. However, if that service potential is not as great as replacement cost, the asset is worth only recoverable amount.

BC29. Recoverable amount is usually defined as the greater of value in use and net selling price. However, as value in use includes the net amount that will be received on disposal, net selling price can be seen as a limiting case of value in use, which is when the value of the remaining service potential is nil.

BC30. The decision process used in the deprival value model can be depicted diagrammatically as follows:



BC31. Responses to CF–CP3 showed some concern about the use of the deprival value model. In particular, respondents felt it would be costly, and impose a disproportionate burden on preparers, to have to consider three possible measurement bases for each asset that is reported.

BC32. The IPSASB agreed that it would not usually be practicable for an accounting standard simply to require the use of the deprival value model. However the key insights of the model are reflected in the Framework, which states:

- Net selling price is clearly relevant when the most resource-efficient use of the asset is to sell it (paragraph 4.4), but is not relevant for assets the services of which would be more valuable (paragraph 4.7).
- Replacement cost is not relevant where it is greater than recoverable amount (paragraph 5.7).
- Value in use is only relevant where it is less than replacement cost and greater than net selling price (paragraph 6.5).

BC33. The IPSASB noted that the deprival value model addresses only the relevance of particular measurement bases and that the objectives of financial reporting and the other qualitative characteristics also are also significant considerations in the selection of a measurement

basis. For example, where the deprival value model suggests that replacement cost is the most relevant basis, historical cost may be preferred because of its simplicity and verifiability.

- BC34. The IPSASB also noted that, where assets are traded on a deep and liquid market to which the reporting entity has access, a current exchange value may be consistent with the deprival value model as, subject to transaction costs, it will equal current replacement cost and net selling price.

Liabilities

- BC35. CF–CP3 explained the application of measurement bases to liabilities as well as assets. It set out the relief value model which is an adaption of the deprival value model for liabilities. Few of the respondents to CF–CP3 addressed the issue of liabilities.
- BC36. The IPSASB concluded that the principles of measurement that apply to assets are equally applicable to liabilities. The discussion in the Chapter adapts the terminology and seeks to explain the necessary differences of emphasis.
- BC37. The discussion of the various measurement bases and the circumstances in which they may be relevant are consistent with the relief value model.

Other Issues

- BC38. CF–CP3 sought the views of respondents on the following two issues related to measurement:
- (a) The treatment of an entity's own credit risk and changes in value attributable to changes in an entity's own credit risk; and
 - (b) Whether the measurement of an asset should reflect only the service potential relating to its existing use, or include the incremental value relating to its possible alternative use.
- BC39. The majority of respondents who addressed these issues considered that they were more appropriately dealt with in the development of accounting standards than within the Framework. The IPSASB concurred with this view, and these are accordingly not dealt with in this Chapter.