

Understanding IFRS Measurements (Cross-cutting Issues)

IFRS Teaching Special Interest Section
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Introduction

- Measurement in financial reporting
 - Critical aspect of the reporting process, viewed by some as underdeveloped conceptually
 - Existing conceptual guidance tends toward lists of measurement attributes (dating from the mid 1980s)
- Goal of the joint IASB/FASB conceptual framework project (phase C) as it relates to measurement
 - Analyze the properties, including strengths and weaknesses, of various measurement attributes (or bases)
 - Provide definitions, when there might not be a common understanding of the terms used to describe (or name) certain attributes (bases)
 - Distinguish between a measurement technique and a measurement attribute (basis)
 - Provide guidance for choosing a measurement attribute (basis)

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Examples of questions to consider

- Mixed attribute or one measurement basis for all assets and liabilities
 - If more than one measurement basis, necessary to devise criteria for determining which basis (or bases) to require (or permit)
- How to consider and apply relevance and representational faithfulness to select measurements
 - How to consider and apply other factors such as comparability and cost constraints
- If items are remeasured, how to display the effects of changes in a measurement in a statement of comprehensive income

Observation:

During summer 2010 the IASB and FASB both reached a tentative decision that:

- the objective of selecting a measurement for an item is to maximize the information about the reporting entity's prospects for future cash flows
 - subject to the ability to faithfully represent the item
 - at a cost that is justified by the benefits
- The Boards have also concluded that it is necessary to consider the effects of measurements and measurement changes on all financial statements

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Available measures

Current measures

- Current entry price (actual or estimated)
- Current exit price (estimated)
- Present value calculations
 - Value in use
 - Fair value based amounts
 - Other

Source: Table 1, June 2009 IASB Staff Paper providing a sample measurement chapter for the conceptual framework project, discussed in December 2009.

Non-current measures

- Past entry price (actual or estimated)
- Past exit price (estimated)
- Adjusted past prices
 - Accumulated or accreted
 - Allocated or amortized
 - Some combination of these
- Undiscounted future cash flows

Observations:

- Some items arise without a specific entry price, e.g., assets/liabilities acquired in a business combination
- Some reported numbers do not seem to qualify as a measure, e.g., equity method reported on the balance sheet

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Factors to consider in selecting a measurement identified as part of the joint project

Decision factors derived from the qualitative characteristics of decision-useful information in the Boards' conceptual frameworks and described in the IASB staff paper

- Level of confidence (easily and precisely verifiable)
- Consistency of measurement for similar items and items used together
- Separability of income components of measure changes
 - Separate components with different effects on cash flow prospects
- How value will be realized from the item (value realization method)
- Cost constraints (compliance burden on preparers and auditors)

Observations:

- Qualitative characteristics: relevance, faithful representation, comparability, verifiability, understandability, subject to cost constraints
- Of the five decision factors, primacy is accorded to cost constraints and value realization method

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More on value realization

- Value realization = Conversion of the economic value of an asset or liability to cash, other assets, services or release from obligation
 - *Direct* value realization occurs in one step, one item at a time
 - *Examples:* Financial instruments, assets (e.g., certain metals or commodities) that will be sold without further processing
 - *Indirect* value realization occurs in multiple steps, often involving other items
 - *Example:* Combine physical assets and other items to create inventory to be sold
 - Value realization is linked to relevance in the Boards' discussions
 - A relevant measure contributes to the assessment of future cash flow prospects and to the evaluation of past performance
 - Therefore, a relevant measure would be based on how the flows an item will generate will arise (that is, how value will be realized)

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More on value realization

Observations and questions to consider:

- Direct vs. indirect realization distinction seems linked to distinctions sometimes seen in financial reporting, including accounting based on business models and management intent
 - Indirect realization is associated with obtaining (creating) items to be sold
 - Applies to assets, not liabilities
 - Are indirect assets (close to) analogous to “operating assets”?
- Direct realization could be associated with holding (or owing) certain financial items to maturity or with transferring (settling) the items
 - Should measurement of direct realization items be affected by whether management intends to hold (owe) or transfer (settle)?
- June 2009 staff paper suggests current measures are generally relevant for certain liabilities and direct realization assets, less so for indirect realization assets
 - Existing guidance requires current exit value measurements (e.g., fair value, net realizable value) for certain *impaired* indirect realization assets.
 - How would this kind of measurement (lower of noncurrent measure and current measure) be affected by the analysis in the staff paper?
 - *Example:* Is an impairment loss relevant if management does not intend to realize value by selling the item?

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More on value realization

- Applying the value realization factor suggests that *how* an item is used by management to create value is pertinent to its measurement
 - *Example 1:* An brand, acquired as part of a business combination, that management intends to discard (does not intend to use or sell)
 - *Example 2:* A financial obligation that management intends to owe to maturity
 - *Example 3:* A debt security that management intends to hold to maturity so as to collect all the contractual cash flows
 - *Example 4:* A nonfinancial asset that management intends to use until its service potential is exhausted

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More on value realization

Observations on the examples and a question to consider:

- Does using something in a specific way alter its economic characteristics?
 - A faithful representation depicts the economic phenomenon
- A current exit value exists for each of these items (it may have to be estimated)
- The current exit value captures the opportunity cost of holding the asset or owing the obligation, given current market conditions
- Relevant information contributes to the assessment of future cash flow prospects and the evaluation of past performance
 - Is this opportunity cost relevant for:
 - Assessing an investment in the entity?
 - Assessing management's performance?
 - *Example:* If management collects all the contractual cash flows of a 4% debt security when the market rate is 5%, does the entity have a loss?
 - *Example:* What is the most relevant measure of assets in a calculation of Return on Assets (ROA)?

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Applying the factors to IFRS 9 Description of the guidance

- IFRS 9 requires: Measure financial assets at amortized cost or fair value on the balance sheet
- *Except that* the fair value option in IAS 39 is retained
 - Fair value option: designate at initial recognition a qualifying financial asset to be measured at fair value with changes included in profit or loss if doing so eliminates or significantly reduces an inconsistency (accounting mismatch) that would otherwise arise
- *Except that* the equity method is retained (because equity method investments are not in the scope of IAS 39)

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Applying the factors to IFRS 9 Description of the guidance

- IFRS 9: Measure financial assets at amortized cost or fair value
 - Amortized cost items must meet two criteria:
 - Business model test: Asset is held within a business model whose objective is to hold the assets to collect contractual cash flows
 - » Reclassification is required if the business model changes
 - » Analysis is neither at the individual instrument level nor at the reporting entity level (the portfolio level?)
 - » The entity need not hold the asset to maturity
 - Contractual cash flows test: Contractual terms of the asset specify principal and interest only
 - » *Except that* management must look to the assets and liabilities of the issuing entity if the financial asset is linked to other securities in a way that affects the concentration of credit risk (for example, arrangements that specify the order in which losses are allocated)
 - Initial measurement is fair value + transaction costs
 - Assets are subject to impairment (impairments can be reversed)
 - Application of the classification criteria is illustrated by examples

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Applying the factors to IFRS 9 Description of the guidance

- IFRS 9: Measure financial assets at amortized cost or fair value
 - Fair value items:
 - Debt instruments held as assets and not classified as being measured at amortized cost (either because of not qualifying or because of applying the fair value option)
 - Equity instruments
 - » *Except*, possibly, equity instruments where cost might be the best estimate of fair value (refer to paragraphs B5.5 to B5.8)
 - Fair value changes included in net income
 - » *Except that* management can designate an equity instrument not held for trading as measured at fair value with changes included in OCI, with no recycling and with dividends included in profit and loss

Observations:

- Equity method investments are not in the scope of the standard
- IFRS 9 eliminates the trading, AFS and HTM classifications, impairment testing except for items measured at amortized cost and the recycling of unrealized gains and losses when securities are sold
- Dividend and price change components of return on certain equity securities will be reported separately (dividends in profit/loss, price changes in OCI)

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Applying the measurement factors to IFRS 9

- Value realization method: How value will be realized can affect the measurement
 - Management can determine measurement of certain financial assets by applying the fair value option or by applying the business model/contractual cash flows tests
 - The business model/cash flows tests are linked to the method of value realization; reclassifications are required if the business model changes
- Consistency of measurement for similar items
 - Similar items are expected to be measured differently
- Separability of income components
 - Dividend and price change components of return on certain equity instruments will be reported in two different places
- Cost constraints (cost to implement)
 - Application of the cash flows test requires analysis of the issuing entity, not just the issued instrument
 - Impairment testing
- Level of confidence
 - Addressed separately (next slide)

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Concerning the level of confidence: IASB proposals on measurement uncertainty analysis disclosures

- June 2010 exposure draft, *Measurement Uncertainty Analysis Disclosure for Fair Value Measurements* (limited re-exposure)
 - Related to the fair value hierarchy (exists in US GAAP, proposed for IFRS)
 - Proposed disclosures—all pertaining to unobservable (Level 3) inputs only
 - Disclose the effects of using different inputs (and how effects were calculated) if changing one or more inputs that could reasonably have been used would change the fair value measurement significantly
 - Ignore inputs associated with “remote scenarios”
 - Take into account the effects of correlations among inputs if relevant (new to the re-exposure)
 - *Example:* Prepayments of residential mortgages are correlated with changes in interest rates

Observations:

- The analysis is *not* intended to predict how a measurement would change in the future because of changes in economic conditions (BC 10) or to provide users with information to ‘second guess’ reported measurements (BC16) or duplicate the IFRS 7 market risk exposure analysis (BC 22-24)
- No requirement to provide a quantitative correlation analysis (BC 20)

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Questions related to measurement

- When should the method of value realization be determinative of measurement (or of accounting treatment generally)?
 - Could be linked to management intent, as in IFRS 9
 - Ignores opportunity cost and (probably) impairs comparability
 - In several uncontroversial settings, accounting treatment is linked to the entity's business model (method of value realization) or seems to result in a number that would not qualify as a measurement
 - *Example:* Heavy construction equipment is accounted for as inventory by a dealer and as fixed assets by a construction company
 - *Example:* Equity method accounting (would the balance sheet number qualify as a measurement)?
- What measurement costs should the standard setter consider?
 - Investments in information systems
 - Investments in valuation/measurement expertise
 - Investments in developing Level 3 (unobservable) inputs
- What is the maximum admissible level of measurement uncertainty?
 - Confidence interval so large that the point estimate is not interpretable?
 - What if there is no practicable alternative to an uncertain measure (e.g.,
uncertain fair value measurements for certain derivatives)?¹⁵