December 2010

Consultation Paper Summary

Phase 3 of 4—Measurement of Assets and Liabilities in Financial Statements

This summary provides an overview of the Phase 3 Consultation Paper *Measurement of Assets and Liabilities in Financial Statements*

Project objectives: The Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities will establish and define the concepts to be applied in developing IPSASs. This Consultation Paper on Phase 3 discusses the measurement of assets and liabilities in financial statements.

The project and stage: In September 2008 the IPSASB published the first Consultation Paper in this project on the objectives, the scope, the qualitative characteristics of financial reporting, and the reporting entity. The IPSASB has considered comments on this paper and has issued an Exposure Draft. A separate Consultation Paper on Phase 2: *Elements and Recognition in Financial Statements* has also been issued. A further Consultation Paper is planned for Phase 4: Presentation and Disclosure.

Next steps: The IPSASB seeks feedback to guide it in further developing the measurement bases that may be adopted for the elements that are recognized in financial statements and their recognition.

Comment deadline: The Consultation Paper is open for public comment until June 15, 2011

Why is the IPSASB undertaking this project?

The purpose of the IPSASB's Conceptual Framework project is to develop concepts, definitions, and principles that respond to the objectives, environment and circumstances of governments and other public sector entities, and therefore, are appropriate to guide the development of IPSASs and other documents dealing with financial reporting by public sector entities.

Many of the current IPSASs are based on International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board (IASB), to the extent that the requirements of those IFRSs are relevant to the public sector.

The IASB is currently developing an improved Conceptual Framework for private sector business entities that is being closely monitored by the IPSASB. Development of the IPSASB's Conceptual Framework is not an IFRS convergence project, and the purpose of the IPSASB's project is not to interpret the application of the IASB Framework to the public sector.

The concepts underlying statistical financial reporting models, and the potential for convergence with them, will be considered by the IPSASB in developing its Conceptual Framework. The IPSASB is committed to minimizing divergence from the statistical financial reporting models where appropriate.

Although all the components of the Conceptual Framework are interconnected, the project is being developed in phases.

To meet the objectives of financial reporting, information is needed that encompasses financial and non-financial information, past and prospective information and reporting on compliance. General Purpose Financial Reports (GPFRs) are more comprehensive than public sector general purpose financial statements (GPFSs). GPFSs are focused on the financial portrayal of past transactions and events, which affect financial position at a point in time and financial performance for a specified period.

This Consultation Paper focuses just on the measurement of assets and liabilities in the GPFSs of public sector entities. The aim is to identify factors that should be considered in choosing measurement bases to be required for particular assets and liabilities in specific circumstances, rather than to identify a single measurement basis that is appropriate in all circumstances.

What preliminary decisions has the IPSASB made already?

The IPSASB has made a number of preliminary decisions regarding the objectives and scope of financial reporting that will be crucial in making further decisions about the measurement of assets and liabilities in financial statements.

GPFRs are financial reports intended to meet the information needs of users who are unable to require the preparation of financial reports tailored to meet their specific information needs.

The scope of financial reporting will evolve in response to users' information needs.

GPFRs of public sector entities include, but are more comprehensive than the financial statements currently dealt with in IPSASs. However, financial statements, including their notes, remain at the core of financial reporting.

The objectives of financial reporting by public sector entities are to provide information about the entity useful to users of GPFRs for accountability purposes and for decision-making purposes.

GPFRs of public sector entities are developed primarily to respond to the information needs of service recipients and their representatives and resource providers and their representatives.

Service recipients require information as input to assessments of such matters as whether:

- The entity is using resources economically, efficiently, effectively and as intended, and whether such use is in their interests;
- The range, volume, and cost of services provided during the reporting period, and the amounts and sources of their cost recoveries, are appropriate; and
- Current levels of taxes or other charges are sufficient to maintain the volume and quality of services currently provided.

Resource providers will require information to enable them to form judgments about such matters as whether the entity:

- Is achieving the objectives established as the justification for the resources raised during the reporting period;
- Funded current operations from funds raised in the current period from taxpayers or from borrowings or other sources; and
- Is likely to need additional (or fewer) resources in the future, and the likely sources of those resources.

What general features do measurement bases have?

Measurement bases may be compared by their general features. Measurement bases may:

- Be historical or current
- Adopt an entry or exit perspective
- Reflect a market or an entity-specific value

Historical or current?

An historical measurement basis reflects an attribute at a past date. In contrast, a current measurement basis reflects the economic and financial environment prevailing at the reporting date.

Entry or exit?

An entry value reflects the consideration payable (or receivable) for the acquisition of an asset (or assumption of a liability). An exit value reflects the amount that will be derived from an asset, often from its sale, but sometimes from its service potential in fulfilling the objectives of the entity.

Market or entity-specific?

A market-based basis of measurement can sometimes promote comparability because the same asset or liability can be expected to be reported by different entities at the same amount.

The term “entity-specific” is used in this context to refer to measurement bases that reflect the economic constraints and opportunities that determine the possible use of the asset or liability by the entity (and not simply its intentions and expectations). These may differ from those of other entities. Entity-specific bases of measurement can sometimes be seen as more relevant than market-based bases.

How do these features relate to specific bases?

The measurement bases discussed in the consultation paper and their relationship to the general features highlighted above can be summarized as shown.

	Historical or current?	Entry or exit?	Market or entity-specific?
Historical cost	Historical	Entry	Entity-specific
Market value	Current	May be either	Market
Replacement cost	Current	Entry	Entity-specific

What are the advantages and disadvantages of historical cost?

Historical cost has a number of advantages. Some consider it to also have deficiencies. These advantages and disadvantages can be considered in the context of the qualitative characteristics of financial reporting shown in bold type.

Advantages

Historical cost is familiar, simple and objective. In other words it is highly **verifiable**.

Because it is simple and familiar, it is easily **understandable**, its use contributes towards **timeliness** and enables financial information to be produced at **low cost**.

Because it reflects the actual transactions undertaken by the entity it may be argued that historical cost is highly **relevant** as well as providing a **faithful representation.**

Disadvantages

In common with other measurement bases, some situations may be difficult to deal with satisfactorily under historical cost. Examples include assets that are donated or provided on subsidized terms, assets that are held for long periods, and collections of assets that are acquired in a single transaction.

Some question whether the historical cost basis provides **relevant** information on the resources held by the entity. Historical cost information may not be considered as relevant to an assessment of future resource needs as information that reflects current prices.

Historical cost information is not always **comparable**: identical assets may be reported at different amounts reflecting the prices prevailing at the time of their acquisition.

What about market values?

The advantages of market values depend upon the nature of the market in which assets (and liabilities) are traded. Where there is a deep and liquid market, market values will exhibit all of the qualitative characteristics of financial information.

In the case of specialized assets, which are commonly used in the public sector, market values are less useful.

Where there is an ideal market

- **Relevance**: The market value of an asset is a relevant measure of its utility to the entity, which cannot be more or less than market value.
- **Faithful representation**: Market values provide a faithful representation of the value of the asset.
- **Understandability:** Market values are easy to understand.
- **Timeliness:** Information based on market values can normally be prepared quickly, and with only simple calculations.
- **Comparability**: Different entities owning the same assets should report them at the same market value.
- **Verifiability**: Market values can be easily verified.

Where assets are specialized

As there is unlikely to be a deep and liquid market, market values may have to be estimated. Such estimation reduces **comparability, verifiability** and **understandability.**

Market values may not be representative of the economic benefits that the entity can derive from the asset, and hence may not be **relevant**, particularly for assets that are held to fulfil public sector objectives.

It may be possible to estimate a market value for a purchaser who can exploit a specialized asset as effectively as the current owner, but this seems excessively hypothetical, and may be considered to lack **relevance.**

What are the advantages and disadvantages of replacement cost?

Replacement cost is defined as:

"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."

Advantages

Replacement cost is arguably highly **relevant** for both accountability and decision-making purposes because it reflects the economic position of the entity at the reporting date. It also permits the cost of providing services to be reported in current cost terms.

Disadvantages

In some cases the calculation of replacement cost is complex. This will reduce the **timeliness**, **comparability** and **verifiability** of information prepared on a replacement cost basis. Such a calculation may also be relatively **costly**.

What is the deprival value model?

The deprival value model provides a means of selecting a measurement basis that is relevant in specific circumstances.

It identifies the amount that would just compensate the entity for the loss of an asset. This is:

- Replacement cost, except where recoverable amount is lower.
- Recoverable amount is the higher of value in use and net selling price.

The relief value model applies the same reasoning to liabilities with some changes in terminology.

All of the bases considered by the deprival value model are current, entity-specific bases. However, (apart from the consideration of transaction costs) the selected bases would not be expected to be significantly different from market values in the case of assets and liabilities that are widely traded on a market.

Use of the deprival value model suggests a basis that is highly **relevant**. However, it is necessary to consider whether the basis that it implies adequately reflects the other qualitative characteristics of financial reporting. Such an analysis ensures that appropriate consideration is given to all the qualitative characteristics and the need to obtain an appropriate balance between them.

Next steps:

The deadline for comments is June 15, 2011.

During the comment period, the IPSASB members are available to discuss the proposals with a wide range of parties.

How can I comment on the proposals?

The Consultation Paper includes specific matters for comment. The IPSASB has not provided tentative views on the issues in order to achieve the widest possible response.

Respondents may choose to answer all questions or just a select few. The IPSASB welcomes comments on any other matters respondents think we should consider in forming our views.

Comment letters will be posted on the IPSASB website.

The IPSASB will carefully consider all feedback and, as usual, discuss responses to the proposals in public meetings.

The IPSASB plans to issue an Exposure Draft setting out our views in 2012.

Stay informed

The IPSASB will announce on its website the dates and location of meetings to discuss feedback on this Consultation Paper.

To stay up to date on the project please visit: www.ifac.org/PublicSector/ProjectHistory.php?ProjID=0066