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Project	**Conceptual Framework**
Topic	**• Measurement implications of the objective of financial reporting** **• Measurement implications of the qualitative characteristics** **• What the measurement chapter should accomplish**

Introduction

1. At their May 4, 2010 joint meeting, the Boards decided to continue to develop preliminary views in the measurement phase of the Conceptual Framework project rather than produce a neutral discussion paper. The Boards also decided to use the discussion questions and alternative views presented in the paper for that meeting as an aid to developing their preliminary views. (For a list of those questions, see Appendix A.)

2. This paper focuses on the first three questions posed in the May paper, because we think that those questions are the most important. As a result of comments received during and after the May meeting, and further development of our own thinking, we have revised some of the alternative views, changed the emphasis of the question about the implications of the qualitative characteristics, and inserted another question about those implications.

3. To some extent, past papers in this phase of the Conceptual Framework project have assumed answers to the questions posed in this paper. Therefore, it may appear that this paper takes a step backward rather than forward. However, although some Board members were comfortable with the answers we had assumed, others were not. As a result, we think it is important to ask these questions explicitly.

4. The questions and their accompanying views consider the following:

   (a) The implications of the objective of financial reporting for measurement (¶¶6 - 18)

   (b) The general implications of the fundamental qualitative characteristics for measurement (¶¶19-22)

   (c) The specific implications of the fundamental qualitative characteristics for historic cost and fair value measurements (¶¶23-37)

   (d) What the measurement chapter should accomplish (¶¶38-48).

5. During July meetings, the staff will ask Board members which view they support for each of the questions included in this paper. With respect to View B of the second question (about the general implications of the fundamental qualitative characteristics), the staff will ask whether Board members support each of the points in subparagraphs (a) through (f) of paragraph 22.

What are the implications of the objective of financial reporting for measurement?

6. The objective of financial reporting is the foundation of the Conceptual Framework. Thus, the concepts and guidance of the measurement chapter of the Framework must logically flow from that objective. (Chapter 1, ¶OB1)

7. Chapter 1 of the Framework states, "The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity." (¶OB2) Chapter 1 goes on to explain that those decisions depend on investors' and creditors' expectations for returns from the entity as a result of investing or extending credit. In turn, those expectations depend on investors' and creditors' assessments of the entity's prospects for future net cash inflows. (¶OB3) Those assessments are affected by the information that investors and creditors receive about the entity's existing resources and claims against the entity, and how well the entity's management and governing board have used the entity's resources (management's stewardship). (¶OB4)

8. This paper uses the expression "maximize information for investment and credit decisions" as a shorthand for the objective of financial reporting and the accompanying explanation of that objective as described above.

9. The following are possible views of the implications for measurement of the objective of financial reporting based on the explanation of that objective in Chapter 1. View A may be described informally as the balance sheet view, View B as the income statement view, and View C as the holistic view.

View A – "The Balance Sheet View"

10. Financial statement measurement is about selecting measurements for assets and liabilities represented on the statement of financial position. All other financial statement elements are derived from changes in, or differences between, assets and liabilities. The best way to maximize information for investment and credit decisions is to select measurements for assets and liabilities that faithfully represent the reporting entity's wealth with respect to those assets and liabilities.

11. That is because the difference between an entity's assets and liabilities represents its wealth at a particular point in time. In one way or another, an investor is buying, selling, or holding a share of that wealth and a creditor is relying on that wealth for future payments of principal and interest. Although past cash flows and other changes in wealth are interesting and may provide some evidence of future changes in wealth, including future cash flows, present wealth is the best starting point for assessing the entity's prospects for future cash flows. Measurements of present wealth also are indicative of management's stewardship, because the entity's wealth at a particular reporting date can be compared with its wealth at previous dates.

12. This view is supported by many of those who would use only current prices or values for asset and liability measurements. Many, if not most, of the Boards' constituents seem to believe that this is the view of the Boards. However, this view also is compatible with supplementing current prices or values on the face of the statement of financial position with disclosures of historic cost or other non-price/non-value measurements in the notes to that statement.

View B – "The Income Statement View"

13. Of all the financial statements, users are most interested in the statement of comprehensive income. Measurements should be selected with revenues and expenses in mind, even if resulting amounts on the statement of financial position are not particularly meaningful. The best way to maximize information for investment and credit decisions is to select measurements for assets and liabilities that result in persistent information (that is, information that recurs from period to period in approximately consistent amounts) about accrual-basis cash flows in the statement of comprehensive income.

14. That is because investors' and creditors' returns will result from future cash flows rather than existing assets. Past revenues and expenses (accrual-basis cash flows) are indications of management's past experience in generating net cash inflows and provide the best means of evaluating management's stewardship. Those revenues and expenses also are the best basis for assessing prospects for future cash flows. Values of existing assets and liabilities are not important unless the entity has both the ability and the intention to realize those values by sale or transfer. Even when those conditions are met, using current prices and values for asset and liability measurements leads to reporting changes in asset and liability measurements in the statement of comprehensive income that can obscure information about stewardship and make it more difficult for users to assess the entity's prospects for future cash flows.

15. This view is supported by many of those who would use only some form of historic cost for asset and liability measurements. However, it also is compatible with using historic cost measurements for assets and liabilities on the face of the statement of financial position while disclosing other measurements, such as fair value, in the notes to that statement.

View C – "The Holistic View"

16. The statement of financial position and the statement of comprehensive income are complements, and both of them provide information that is useful is assessing both management's stewardship and a reporting entity's prospects for future cash flows. The statement of financial position gives a picture of a reporting entity's stock of resources, net of claims against the entity, and the statement of comprehensive income portrays the flows and changes in value of that stock between two reporting periods. The best way to maximize information for investment and credit decisions is to consider the information that would result in both statements from selecting a particular measurement for an asset or liability, or groups of assets or liabilities.

17. The reason is that investors' and creditors' returns will be based on both the entity's existing assets and liabilities (wealth) and management's ability to increase the entity's wealth in the future. Past unrealized value changes are important as indicators of the effect of changes in market conditions on the existing assets and liabilities and of the opportunity costs of management's decisions not to realize gains and losses. Past accrual-basis cash flows and realized changes in values are important as indicators of management's ability to actually realize a return. Selecting financial statement measurements considering either the statement of financial position alone or the statement of comprehensive income alone will not maximize information for investing and credit decisions.

18. Under this view, more than one type of measurement would be expected both on the face of the statement of financial position and in note disclosures.

Question for the Boards

Question 1: Implications of the objective of financial reporting
Are the views about the implications of the objective properly articulated? Are there other views that should be described? Do you support any of these views? If so, which one? If not, what is your view?

What are the general implications of the fundamental qualitative characteristics of useful information for measurement?

19. Chapter 3 of the Framework states that the qualitative characteristics of useful financial information identify the types of information that are likely to be most useful to the primary users of financial reports for making decisions about reporting entities that are based on financial information (QC1). The fundamental qualitative characteristics are relevance and faithful representation (QC5). It follows that those two characteristics must be considered in selecting measurements. However, there are alternative ways that the measurement chapter could build on that mandate.

View A

20. Relevance and faithful representation are adequately described in Chapter 3. Thus, no additional discussion is needed about what those characteristics might imply for measurement or how they might be used for the selection of measurements. When setting standards for measurement, Board members should use their own understanding of what relevance and faithful representation mean for measurement and their own judgment about how those characteristics should be used to select measurements.

21. This view could be compatible with any of the views presented above on the implications for measurement of the objective of financial reporting.

View B

22. An explanation of how relevance and faithful representation particularly relate to measurement would be useful and should be developed within the measurement chapter. That explanation would differ depending on the Boards' view of the implications for measurement of the objective of financial reporting. However, as an example, if the Boards choose View C (the holistic view), the explanation might include the following points:

    (a) The fundamental characteristics of relevance and faithful representation should be considered in light of an item's total representation and not just the description and measurement of that item on the face of the statement of financial position (SFP). The total representation of an item includes related information in the notes to the financial statements, related accrual-basis cash flows reported in the statement of comprehensive income (SCI), related changes in the measurement of that item reported in the SCI, and related cash flows reported in the statement of cash flows.

    (b) The objective of financial reporting determines a measurement's relevance. Thus, the most relevant measurement in any measurement selection decision is the one that best helps users of financial reports assess their prospects for net cash flows from actual or planned investments in, or extensions of credit to, the entity. Such a measurement should help users assess the amount, timing, and uncertainty of the reporting entity's future cash flows (which is determined by the entity's existing resources and claims and by management's ability to use those resources).

(c) The concept of value realization can provide insight into the relevance of alternative asset measurements and their resulting effect on the components of comprehensive income. Assets have economic value either in use, in exchange, or both. The amount, timing, and uncertainty of a reporting entity's future cash flows may differ depending on whether value is realized in use or in exchange. Understanding the value realization possibilities for a particular asset, or for a class of assets, will facilitate the selection of measurements.

(d) The concept of value sacrifice can provide insight into the relevance of alternative liability measurements and their resulting effect on the components of comprehensive income. Extinguishment of liabilities requires the sacrifice of economic value. That sacrifice may result from fulfilling the liability according to its contractual, statutory, or judicial terms; from negotiating a settlement with the counterparty; or from a market exchange (either a transfer of the liability to a third party or a purchase of the related asset in a secondary market). The amount, timing, and uncertainty of a reporting entity's future cash flows may differ depending on the way that value is sacrificed to extinguish a liability. Understanding the value sacrifice possibilities for a particular liability, or for a class of liabilities, will facilitate the selection of measurements.

(e) Generally, SFP information is more important for assets and liabilities whose exchange value is relevant to users. In contrast, SCI information is generally more important for assets and liabilities whose use value is relevant to users.

  (i) More than one measurement might be relevant to users, and, if so, a second measurement might be disclosed in the SFP or in the notes.

  (ii) In some cases, separating the effects of SFP measurements on comprehensive income into those resulting from flows and those resulting from other value changes may produce more relevant information than reporting only the aggregate effect. Similarly, separating those other changes in an item's measurement into persistent components (such as declines in expected cash flows due to probability of default) and transitory components (such as changes in value due to changes in market interest rates) may increase their predictive value, and thus the relevance, of the total representation.

(f) Although measurements must be selected for particular assets and liabilities, users usually are not interested in information at that level. Moreover, most financial statement information is aggregated to some degree. Therefore, the relevance of measurements for particular assets or liabilities can be preserved only if all the assets or liabilities with which they are grouped in a financial statement line item (including subtotals and totals) use the same measurement.
Questions for the Boards

Question 2: Implications of the fundamental qualitative characteristics

Are Views A and B about the general implications of the fundamental qualitative characteristics properly articulated? Are there other views that should be described? Which view do you generally support? (This question is not about whether you support the specific points in B(a) through B(f). That is question 3, which will be asked only if a majority of board members generally support View B.

Question 3: Particular points in View B

If you support View B generally, and you agree with View C in Question 1, are there any particular points in (a) through (f) that you do not support or that need better articulation? Are there any particular points that you would add to View B? If you agree with View B generally but do not agree with View C in Question 1, do you have any suggestions about the points to be included in View B?

What are the specific implications of the fundamental qualitative characteristics for historic cost and fair value?

23. Historic cost describes a set of measurements rather than a single measurement, and fair value is not the only current value that might be useful. However, most debates about financial statement measurement pit historic cost against fair value. Therefore, attempting to answer the above question may be a useful exercise, even if the question never appears in a due process document in this form.

24. The three views presented below may be associated with the three views about the implications of the objective of financial reporting described in paragraphs 10 through 17 above.

View A

25. This view assumes View A about the objective of financial reporting, as described in paragraphs 10-12, above. In that view, maximizing information for investment and credit decisions focuses on selecting measurements for assets and liabilities on the statement of financial position. Given that view, the most relevant financial statement measurement for a particular asset or liability (or group of the same) is the one that maximizes information on the statement of financial position about the reporting entity's prospects for future cash flows from that asset or liability. If that measurement can be faithfully represented, then it should be used.

26. In almost all cases, fair value will fit the above description better than historic cost. Fair value not only indicates the cash flow that would be realized from selling an asset (or that would be sacrificed in extinguishing a liability) at the reporting date, but also incorporates the market's expectation about future cash flows that might be realized (sacrificed) in relation to that asset or liability.

27. Historic cost should be used as a measurement only if it is readily available and one of the following circumstances exists:

    (a) A level-three fair value estimate is the only alternative to historic cost and the estimate entails such a high degree of subjectivity and/or uncertainty that it is not relevant

    (b) Fair value can be faithfully represented but is cost prohibitive and no other measurement is more relevant than historic cost.

View B

28. This view assumes View B about the objective of financial reporting as described in paragraphs 13-15 above. In that view, maximizing information for investment and credit decisions focuses on selecting measurements for revenues and expenses on the statement of comprehensive income.

29. Given that view, the most relevant financial statement measurement for a particular asset or liability (or group of the same) is the one that maximizes information on the statement of comprehensive income about the reporting entity's prospects for future cash flows based on its most recent revenues and expenses. If that measurement can be faithfully represented, then it should be used.

30. In many cases, historic cost will fit the above description better than fair value. The use of historic cost is consistent with the fact that most assets and liabilities associated with producing the persistent components of a reporting entity's comprehensive income are used jointly for that purpose. Assigning a separate fair value to assets and liabilities that produce income jointly will not provide decision-useful information. Using historic cost also avoids including non-persistent changes in assets and liabilities in the statement of comprehensive income until those changes are realized as cash flows.

31. Fair value should be used as a measurement only in the following circumstances:

(a) An asset or liability has no historic cost (for example, there was no price transaction) and fair value is neither cost prohibitive nor subject to such a high degree of uncertainty as to be irrelevant

(b) An asset or liability is used for trading in a market or for storing market value (including speculative derivatives) rather than for producing income in conjunction with other assets and liabilities.

View C

32. This view assumes View C about the objective of financial reporting as described in paragraphs 16 and 17, above. In that view, maximizing information for investment and credit decisions requires that the selection of a financial statement measurement consider the effect of that selection on both the statement of financial position and the statement of comprehensive income.

33. Given that view, the most relevant financial statement measurement for a particular asset or liability (or group of the same) is the one that maximizes the collective information about the reporting entity's prospects for future cash flows from both the statement of financial position and the statement of comprehensive income. The concepts of value realization (for assets) and value sacrifice (for liabilities) can be used, albeit imperfectly, to select the most relevant measurement that is compatible with this view.

34. On the one hand, if the expected cash flows from disposing of an asset in an exchange exceed the expected cash flows from using that asset, or if the minimum sacrifice required to rationally extinguish a liability would be in a market transfer or exchange, then fair value is the most relevant measurement for that asset or liability.

35. On the other hand, if the expected cash flows from using an asset exceed the expected cash flows from disposing of it in an exchange, or if the minimum sacrifice required to rationally extinguish a liability would be in a settlement or performance of the liability with the counterparty, then fair value is less likely to be relevant. However, that does not necessarily imply that historic cost is the best alternative. A measurement other than fair value or historic cost may be more relevant, such as value in use or entry price for assets, or a current value other than fair value for liabilities. Whichever measurement best informs users about the entity's prospects for future cash flows, and can be faithfully represented with benefits justifying costs, should be selected. In some cases that measurement will be some form of historic cost.

36. Consistent with this view, it may be necessary in some cases to provide users with more than one measurement for an asset or liability (either on the face of the statement of financial position or as a disclosure in a note). For example, the expected cash flows from using a particular asset may be more important to financial statement users than the expected cash flows from an exchange of that asset. In that case, fair value would not be the first choice for a measurement. However, the fair value of that asset might be sufficiently important to users as secondary information to justify presenting it in the statement of financial position along with the most relevant measurement, or disclosing it in a note.

Question for the Boards

Question 4: Specific implications of QCs for historic cost and fair value
Are the views about the specific implications of the fundamental QCs for historic cost and fair value properly articulated? Are there other views that should be described? Which view do you support?

What should the measurement chapter accomplish?

37. If the Boards are able to answer the first four questions, the staff would like to discuss this question with the alternative views that follow. We think that all the following views are compatible with any of the three views on the implications of the objective of financial reporting. However, as noted below, the following views might not be compatible with both views on the general implications of the fundamental qualitative characteristics.

View A

38. The measurement chapter should be very basic. At most it should:

    (a) List and describe possible measurements

    (b) Arrange or classify the measurements in a useful manner

    (c) Describe the advantages and disadvantages of each measurement in terms of the qualitative characteristics of useful information.

39. This view is compatible with View A about the general implications of the fundamental qualitative characteristics for measurement. However, View B probably would not lead to this view about the measurement chapter.

View B

40. The measurement chapter should include those aspects mentioned in View A. In addition, the measurement chapter should discuss at a conceptual level how the qualitative characteristics and cost constraints should be considered together as factors in identifying an appropriate measurement. However, that guidance should not go so far as to conclude that a particular measurement should be used in particular situations.

41. This view probably is not compatible with View A about the general implications of the fundamental qualitative characteristics, but is compatible with View B about those implications.

View C

42. The measurement chapter should include those aspects mentioned in View B. In addition, the chapter should prescribe appropriate measurements and the situations in which they should be used.

43. This view probably is not compatible with View A about the general implications of the qualitative characteristics, but is compatible with View B.

View D

44. The measurement chapter should prescribe a hierarchy of measurements. In order to accomplish that, the chapter should:

    (a) Reduce the list of possible measurements to a smaller set

    (b) Evaluate the advantages and disadvantages of each measurement in the set

    (c) Rank the measurements

    (d) Provide guidance for determining when to use the second-highest ranked measurement instead of the highest ranked, and so forth down the ranking.

45. This view probably is not compatible with View A about the general implications of the qualitative characteristics, but is compatible with View B.

View E

46. The measurement chapter should prescribe a single measurement to be used for all assets and liabilities in all circumstances. In order to accomplish that, the chapter should:

    (a) Reduce the list of possible measurements to a smaller set of measurements that could realistically serve as the sole measurement. At a minimum, that set would include some form of adjusted transaction price and some form of current market price

    (b) Evaluate the advantages and disadvantages of the alternatives

    (c) Conclude which single measurement is best

    (d) Provide guidance for estimating the single measurement when it cannot be quantified directly.

47. This view probably is not compatible with View A about the general implications of the qualitative characteristics, but is compatible with View B.

Question for the Boards

Question 5: What the measurement chapter should accomplish
Are the views about what the measurement chapter should accomplish properly articulated? Are there other views that should be described? Which view do you support?

Appendix A: Discussion Questions for Developing Preliminary Views

1. What are the implications of the objective of financial reporting for measurement?
2. What are the implications of the qualitative characteristics of useful information for measurement?
3. What should the measurement chapter accomplish?
4. What should be the scope of the measurement chapter?
5. Should the measurement chapter state that it is intended primarily for use by the Boards in setting standards?
6. How should the term *measurement* be used in the measurement chapter?
7. If *measurement* is used in an informal sense, should the measurement chapter explain the difference between its informal use of the term and the term's formal meaning?
8. Should the measurement chapter classify measurements into categories?
9. Should the chapter make a distinction between initial and subsequent measurement?
10. Should the measurement chapter discuss concepts of capital maintenance?
11. Should the measurement chapter discuss the concept of going concern?