



**Board Meeting Handout
Conceptual Framework**

November 5, 2008

PURPOSE

1. The purpose of this meeting is to discuss a possible way forward for the measurement phase of the conceptual framework project. The Board will discuss five factors recommended by the staff that might be considered in determining the most appropriate way to subsequently measure assets and liabilities that are recognized in the statement of financial position. Measurement at initial recognition will also be briefly discussed.
2. For purposes of this discussion, *measurement* refers not only to those quantifications that qualify as measurements in a strict sense but also to estimates of such measurements and to formulaic numbers used in financial statements that may not qualify as measurements in a strict sense.
3. Because the draft framework chapter on objectives states that users need similar information to assess cash flow prospects and stewardship, only the assessment of prospective cash flows will be mentioned in the remainder of the memorandum.

MEASUREMENT AFTER INITIAL RECOGNITION

4. The objective of financial reporting entails providing decision-useful information to present and potential investors and creditors who are trying to assess prospects for future cash flows. Items recognized in financial statements should be measured in ways that facilitate those assessments.

The Theoretical Ideal

5. Given the objective of financial reporting, the theoretically ideal way to measure an asset or liability would be to determine the actual outcome of having or using that item (that is, the amount and timing of future cash flows or other economic value flows) and discount

that outcome at the time value of money. Unfortunately, no outcome is ever 100 percent certain until it actually occurs. There is always some possibility that the amount or timing of actual cash flows will vary from what they are forecast to be.

6. Thus, the theoretically ideal measurement method could only be used by waiting to recognize an asset or liability until after the ultimate cash flow outcome of that item has occurred. That would be feasible only if the outcome were to occur shortly after the reporting date. For many items, the ultimate outcome will not be known until after a financial report has been issued, years later in many cases. Waiting for a future outcome to occur would also be counter to the idea that financial statements should reflect facts and conditions known to exist at the reporting date.

Real Choices

7. Because the ideal is unattainable, the Boards will need to determine the best measurement available in real situations.
8. The Board has discussed several possible measurement bases. Those bases may be grouped into three main categories, as follows:
 - a. Current-value based (including market prices and price estimates)
 - b. Past-value based (including transaction prices, original costs, and original proceeds, with possible adjustments such as depreciation, interests accruals, and valuation adjustments or allowances)
 - c. Anticipated-value based (including asset measures based on anticipated selling prices and liability measures based on anticipated settlement outcomes).

Under Optimal Measurement Conditions

9. Under optimal conditions for measurement that can exist in real situations, a current-value measurement clearly would be better for assessing prospects for future cash flows than a measurement based on past or anticipated values.

10. The optimal conditions for using a current value measurement include:
 - a. The current value can be observed at little or no cost
 - b. The item to be measured is readily convertible to cash, that is, it is either:
 - (1) An asset that represents a right to receive cash or that is readily marketable for a known amount of cash, or
 - (2) A liability that represents an obligation to pay cash or that could readily be laid off for a known amount of cash
 - c. Changes in the current value of an asset or liability can be separated from related cash flows and contractual accruals, thus facilitating user assessment of prospective cash flows
 - d. Current values are available for all assets or liabilities that generate cash flows as a group.

Under Suboptimal Measurement Conditions

11. Optimal measurement conditions do not exist for most assets and liabilities of most reporting entities. Therefore, in identifying a measurement basis to be used in a particular standard, the Board usually will need to consider all three categories of measurement bases mentioned in paragraph 5.
12. Thus, the Board's standards-level decisions about measurement of specific items in the statement of financial position would need to consider the following factors whenever optimal conditions for using current values do not exist:
 - a. *Value/flow weighting and separation.* The relative importance to users of information about the current value of the asset or liability versus information about the cash flows generated by the item, as well as the ease and precision with which the flows can be separated from the value changes (an indication of relevance)

- b. *Confidence level.* The level of confidence that can be placed on alternative measurements as representations of the asset or liability being measured (an indication of faithful representation)
- c. *The measurement of similar items.* Items of a similar nature should be measured in similar ways (an indication of comparability)
- d. *The measurement of items that generate cash flows together.* Items that generate cash flows as a unit should be measured the same way (an indication of understandability)
- e. *Cost-benefit.* An assessment of the ratio of the benefits that would be derived from alternative measurements to the costs of preparing those measurements (an indication of the primary limiting factor in financial reporting).

Under the optimal conditions listed in paragraph 7, all five factors would support the use of a current value. With anything less than those conditions, the five factors would need to be evaluated for each measurement basis considered.

MEASUREMENT AT INITIAL RECOGNITION

- 13. The mechanics of double entry bookkeeping result in most items being recognized at the transaction price (the value of the consideration given or received in exchange for the newly recognized item). There are three notable exceptions:
 - a. Assets acquired and liabilities incurred in business combinations or other bundles
 - b. Internally constructed or internally developed assets
 - c. Assets and liabilities for which there are no transaction prices.

QUESTION FOR THE BOARD

- 14. The staff will ask Board members whether they agree with the approach to measurement outlined in this Board handout. If there is sufficient support for that approach, the staff will ask Board members for direction for discussing and developing supporting detail.