

DRAFT COMMENT LETTER
Comments should be submitted by 31 December 2012 to
Commentletters@efrag.org

Notes to EFRAG's constituents

EFRAG has decided to comment on the paper "Toward a Measurement Framework for Financial Reporting by Profit-Oriented Entities" issued by the Canadian Institute of Chartered Accountants. To facilitate comments from its constituents, EFRAG has included its main messages in this cover letter. Appendix 1 includes the more detailed basis for the comments that may also be studied by constituents responding to this draft comment letter. Appendix 2 includes a reference table, linking the questions raised in the paper with the paragraphs of this [draft] comment letter. Appendix 3 includes a high level summary for constituents of the measurement approach suggested in the paper and three examples illustrate the implications of the proposed approach.

[Date]

The Canadian Institute of Chartered Accountants
277 Wellington Street West
Toronto, Ontario
Canada
M5V 3H2

Attention: Alex Milburn, PhD, FCA

Re: Toward a Measurement Framework for Financial Reporting by Profit-Oriented Entities

Dear Alex,

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the research paper: *Toward a Measurement Framework for Financial Reporting by Profit-Oriented Entities*, issued by the Canadian Institute of Chartered Accountants in 2012 (the 'paper').

EFRAG welcomes the work carried out in relation to the paper. We agree with the paper that stewardship should be considered in determining how assets and liabilities should be measured, and that an appropriate measurement basis should not rely on estimates with large margins of errors when applied in practice. However, we disagree with the measurement model proposed in the paper and that measurement at Current Market Value provides the most useful information when this value is practicable of faithful representation.

The purpose of a measurement framework in selecting a measurement basis

We have based our comments on our conclusion that the purpose of a measurement framework should be to provide directions for standard setters in choosing the best measurement basis under given circumstances. The best measurement basis is the one

that provides the most useful information to users of financial statements. We believe this means that measurement should not only be considered from the perspective of depicting an entity's financial position. It should also be considered how an entity's performance is best reflected.

The proposed model does not always result in the most useful information

The paper proposes that Current Market Value is the ideal (most relevant) measurement basis, when the value is practicable of faithful representation. The argument is that the Current Market Value of an asset or liability embodies seven properties that are not all embodied in other identified measurement bases. We disagree that the model proposed in the paper will always lead to the most relevant information. We do not think that the proposed properties of Current Market Value identified in the paper will always produce the most useful financial information and the model of the paper will not always result in the proposed properties being reflected.

For example, the paper proposes that matching current input costs sacrificed against current revenues is a better starting point for estimating an entity's future sustainable earning than historical cost-based accounting, and reflecting holding gains and losses on input assets and liabilities always provides useful information. We do not agree that this will always be the case.

Firstly, we believe that information about actual cash flows is often considered more useful for predicting future cash flows than information about hypothetical cash flows from transactions and events (the cash flows as they would have been had a contract been agreed and the related work started and completed on the date of revenue recognition).

Secondly, the model proposed would not take into account that an entity might have used another input mix if the input prices during the completion had been similar to the prices at the balance sheet date. Accordingly, the figures resulting from the model would not always reflect a good estimate of what cash flows would have been if it had been possible to agree on and complete a contract on the same date.

In addition we think that matching current input costs with current revenue does not always provide a good basis for assessing stewardship. The production process of many assets takes time, and matching current input costs with current revenue could thus reflect a hypothetical or impossible scenario that would be irrelevant for assessing stewardship. We also believe that reporting holding gains and losses on input assets and liabilities would be irrelevant if the entity is not generating its cash flows from holding and selling these assets and liabilities. For self-constructed assets the reported holding gains and losses may even represent very abstract information, as it may be impossible to sell input assets that have been used to create another asset.

Considering the effects on the balance sheet, we note that the proposed model results in performance obligations being recognised at Current Market Value (if this is practical of faithful representation). We do not think that this would always lead to the most relevant information. Measuring performance obligations at Current Market Value means that if an entity has entered into a fixed price contract with a customer, and the market value of this type of contract increases, the net effect of the contract should be recognised as a liability. We do not think this provides useful information when completing the contract would still result in a net cash inflow to the entity.

We also note that the paper considers that measurement based on publicly available information of estimates of future economic benefits; made at the time of the measurement, always result in more useful information than non-publicly available information at the measurement date or another date. In this regard we note that, based

Toward a Measurement Framework for Financial Reporting by Profit-Oriented Entities

on anecdotal evidence, at least some users do not think that financial statements should reflect publicly available information at particular points in time. Instead financial statements should enable users in making their own forecasts.

Furthermore, EFRAG disagrees with the paper that a measure reflecting 'expected value probabilities', taking into account all perceived possible outcomes, will always result in the most useful information. For example, EFRAG considers that it will sometimes provide more useful information to measure provisions based on the most likely outcome.

Measurement of an asset or liability should be practicable of faithful representation

We agree with the paper that what it terms 'practicable of faithful representation' is essential in relation to measurement in the financial statements. In other words, if a measurement basis in practice would result in estimates with large margins of errors, disclosure about the uncertainty cannot solve this issue, and another measurement basis should be chosen.

A way forward

EFRAG does not believe that it will be possible to identify an ideal measurement basis. Instead we think the role of a measurement framework should be to explain the properties of various measurement bases and by reference to users' needs provide directions on when the different properties are important. In addition, it should provide directions on how to choose between alternative measurement bases when the most relevant basis would not result in assets and liabilities being practicable of faithful representation.

Absent detailed knowledge on how users use financial statements, EFRAG believes that implications of a measurement basis on both an entity's financial position and performance should be considered. In other words, a framework on measurement should prevent standard setters from choosing a measurement basis for the benefits of depicting an entity's financial position, if this would impede relevant performance reporting.

EFRAG believes that in order to provide relevant performance reporting, measurement should reflect how an entity is generating its cash flows (the sources of its earnings) and be linked to actual cash flows. If purchase efficiency, for example, is an important performance driver, it may be relevant to provide information about holding gains and losses. On the other hand, if an entity is only generating its cash flows from transforming raw materials into finished goods, information about holding gains and losses on assets may be irrelevant and should thus not be presented in the income statement. In order for performance reporting to be relevant, we also think it is important that measurement bases of various assets and liabilities are not considered in isolation.

Finally, we think that a conceptual framework for measurement should work for all entities. In this respect we note that we found it difficult to apply the distinction between operating, financing and investing activities to financial institutions such as banks and insurance companies.

The bases for our comments are provided in Appendix 1. Appendix 2 includes a reference table, linking the questions raised in the paper with the paragraphs of this [draft] comment letter. [Appendix 3 includes a high level summary of the measurement approach suggested in the paper and three examples that illustrate the implications of the proposed approach.]

Toward a Measurement Framework for Financial Reporting by Profit-Oriented Entities

If you would like to discuss our comments further, please do not hesitate to contact Rasmus Sommer or me.

Yours sincerely,

Françoise Flores

EFRAG Chairman

APPENDIX 1 – Basis for comments

The purpose of a measurement framework in selecting a measurement basis

- 1 The paper 'Toward a Measurement Framework for Financial Reporting by Profit-Oriented Entities' ('the paper') proposes that Current Market Value is the ideal (most relevant) measure of assets and liabilities for financial reporting purposes. According to the paper, the reason is that Current Market Value of an asset or liability embodies seven properties that are not all embodied in other identified measurement bases, and that other measurement bases do not have any additional more relevant properties (paragraph B15 of the paper).
- 2 According to the paper (paragraph 28), the seven properties that Current Market Value of an asset or liability embodies are:
 - (a) An estimate of future economic benefits or sacrifices (ultimately cash flows) to result from events or circumstances that have taken place.
 - (b) An expectation of possible variations in the amounts and/or timing of future economic benefits or sacrifices (reflecting expected value probabilities that take into account all perceived possible outcomes).
 - (c) The time value of money, representing the "risk-free" rate of interest.
 - (d) A price for bearing the uncertainties of the economic benefits or sacrifices inherent in the asset or liability.
 - (e) The incorporation, based on publicly available information, of conditions current at the time of measurement with respect to properties (a) – (d) above.
 - (f) A price that reflects the relative economic efficiency and effectiveness of competing alternatives to the asset or liability as a consequence of incorporating publicly available information.
 - (g) A price that is independent of the private expectations and intentions of individual entities.
- 3 In the view of EFRAG, the purpose of a measurement framework should be to provide directions for choosing the best measurement basis under given circumstances. The best measurement basis is the one that provides the most useful information to users of financial statements.
- 4 When determining what measurement basis will result in the most useful information, EFRAG thinks that performance reporting should play a central role. In other words, measurement should not only be considered from the perspective of what various assets and liabilities should be measured at in the balance sheet. It should also be considered how performance is reported in the most useful manner, and how this will impact measurement of assets and liabilities.
- 5 We therefore believe that the paper should have included an explanation of why measurement at Current Market Value would result in useful performance reporting and in general would provide the most useful information to users of financial statements.

- 6 We consider that examining whether the proposed properties of Current Market Value would result in the most useful information could be a study – or a series of studies – in itself, and we have not performed such studies. However, as explained in more detail below EFRAG doubts that some of the proposed properties always result in the most useful information. In addition, we think that the manner in which the paper requires Current Market Value to be applied will not always result in the proposed properties being reflected in financial statements (even when Current Market Value is practicable of faithful representation).
- 7 The remainder of this appendix is structured as follows:
- (a) Paragraphs 8 to 49 comment on five of the seven properties that the paper proposes that Current Market Value of an asset or liability embodies. In those paragraphs we provide some thoughts on whether these proposed properties of Current Market Value would always result in the most useful information and whether the manner in which the paper requires Current Market Value to be applied will always result in the proposed properties of Current Market Value being reflected.
 - (b) Paragraphs 50 to 59 present a few comments to the concepts of ‘practicability’ and ‘faithful representation’ as defined in the paper.
 - (c) Paragraphs 60 to 67 comment on how a measurement framework could be developed.

The proposed model does not always result in the most useful information

- 8 As mentioned above, EFRAG disagrees that the measurement model proposed in the paper will always result in the most relevant information. In the following paragraphs we have included some comments to five of the seven properties of Current Market Value (see paragraph 2 above). For each of these properties, we are arguing that they may not always make financial information more useful and/or that the measurement model of the paper will not always result in the proposed property being reflected. The comments are based on the assumption that Current Market Value is practicable of faithful representation.

The incorporation, based on publicly available information, of conditions current at the time of measurement

- 9 The paper assumes that that the incorporation, based on publicly available information, of conditions current at the time of measurement with respect to the properties listed in paragraphs 2(a) to 2(d) above is useful. EFRAG interprets this to mean that a market estimate of future economic benefits or sacrifices to result from events or circumstances that have taken place is considered useful.
- 10 We note that there is not much direct evidence on how users use financial statements. However, we are aware that at least some users do not think that financial statements should reflect publicly available information (such as market forecasts) at particular points in time. Instead financial statements should enable users in making their own forecasts at a point in time, when the users need to make their decisions.

An estimate of future economic benefits or sacrifices (ultimately cash flows) to result from events or circumstances that have taken place

- 11 The paper assumes that it is always useful that the measurement of an asset or a liability reflects an estimate of future economic benefits or sacrifices (ultimately cash flows) to result from events or circumstances that have taken place.
- 12 EFRAG does not think that the measurement of an asset or a liability should necessarily reflect estimates of future cash flows. Instead measurement of assets and liabilities should result in financial statements that enable users to make cash-flow projections. Furthermore, EFRAG assesses that the model proposed in the paper would not always result in the best basis for such projections.
- 13 We have considered a hypothetical example [see Example 3 in Appendix 3] where the price of a ship (that is the price of a performance obligation to construct a ship), depends on the price of the required raw materials, in this case mainly steel. In the example an entity offers to construct a ship for a fixed price and purchase the raw materials as soon as the order is agreed.
- 14 We think that the proposed model means that when an entity is constructing an asset, this asset should be measured at the current market prices of the input assets unless the output has a Current Market Value that is practicable of faithful representation.
- 15 Accordingly, the steel that is included in the raw material inventory or forms part of a partly constructed ship, for which revenue has not yet been recognised, should be measured at the Current Market Value at the balance sheet date. Similarly, the performance obligation should be measured at its Current Market Value at the balance sheet date.
- 16 This means that if the current market price of steel is increasing, the entity would report a holding gain on the steel. However, as the example assumes that the price of a ship depends on the price of steel, the Current Market Value of the performance obligation to construct a ship would also increase. This would result in the recognition of a loss and a liability. This loss is 'used' to increase income to the Current Market Value of the performance obligation, when revenue from the ship is recognised. The revenue will therefore reflect the cash inflows, that would have been received had the contract been agreed at the time of revenue recognition. Likewise, the costs of goods sold would reflect the prices of the inputs used to produce the output at the date of revenue recognition.
- 17 We do not believe that this information would always be useful for predicting future cash flows for the following reasons:
 - (a) Without other evidence, EFRAG believes that often the most useful information for predicting future cash flows is information that is closely linked to actual cash flows (that is revenue figures that are closely linked to the cash inflows that an entity has received or will receive from its customers, and cost figures that are closely linked to cash-outflows to suppliers). The performance figures resulting from the paper would on the other hand reflect cash flows from hypothetical transactions and events (the cash flows as they would have been had a contract been agreed and completed on the date of revenue recognition). We disagree with the arguments presented in the paper that:
 - (i) measuring inputs sacrificed at their current prices when they are matched against revenues recognised at their current prices [always]

represents the most relevant record of the results of the operating activities of an entity that have taken place in a reporting period (paragraph D11 of the paper); and

- (ii) matching current input costs sacrificed against current revenues [always] seems likely to be a better starting point for estimating an entity's future sustainable earnings than historical cost-based accounting (paragraph D18 of the paper).
- (b) We acknowledge that the reported margins under the proposals in some cases under ideal circumstances may reflect markets' forecasts of future margins. However, the forecasts do not, for example, take into account that an entity may have used another input mix had the input prices been similar to the prices at the balance sheet date when the asset was constructed. When an entity can apply different input assets to produce its output, and the prices of these input assets fluctuates independently, we cannot follow the argument presented in the paper that matching the current prices of the input used against current revenues would be a better starting point for estimating an entity's future sustainable earnings than historical cost-based accounting.
- (c) We do not believe that it provides useful information to recognise a liability and a loss in relation to a contract that is profitable. As explained in paragraph 16 above, a liability is recognised in relation to a performance obligation when the Current Market Value of the performance obligation increases. This happens even when the entity would still have net cash inflows from completing the performance obligation. In our mind, recognising a liability would signal that a contract is not profitable. We acknowledge that it could be claimed that the contract to construct a ship, explained in paragraphs 13 to 16 above, is only profitable because the entity is purchasing the raw materials at contract inception. It could therefore be argued that constructing the ship is loss making, but the entity's hedging strategy makes the contract profitable. We would, however, disagree with such an argument. The entity is purchasing the raw materials because it has to construct the ship and it cannot buy the raw materials at the same date as it is recognising the revenue from the ship, as it simply takes time to build a ship. The purchase therefore, mainly, reflects necessities in the production rather than a hedging decision.
- 18 EFRAG also disagrees with paragraph D14 of the paper that there is [always] important information value in the separation of price change effects from the measure of current operating profit since each has potentially different implications for the future cash-generating ability of an entity. The paper considers that this information would improve the ability of users to understand how an entity makes money (i.e. by enabling an understanding of the extent to which its reported profits are the results of possibly transitory input asset price changes versus the results of its cash-generating process for transforming the current cost of inputs into revenue). The example in paragraphs 13 to 16 above, illustrates that the information is misleading, when an entity is completing a contract with a customer and the price of the contract is linked to the price of the input assets to complete the contract, and these input assets have been purchased. However, in some other circumstances, we acknowledge that the information could be useful.
- 19 In cases, for example, where an entity is generating cash flows from holding inventory and purchase efficiency is an important performance driver, we consider that gains and losses on holding inventory could be useful information to present either on the face of the income statement or in the notes. The information may provide information on purchasing efficiency versus production efficiency. In such

cases it could therefore be useful, on a continuous basis, to remeasure input assets at their current values in input markets.

- 20 When it comes to users' ability to predict future cash flows, we also note that there is evidence that when market frictions exist (the market is not perfect) more timely recognition of bad news (conditional conservatism) decreases information asymmetry among investors¹.
- 21 We therefore agree with the paper that it is necessary that a conceptual framework on measurement should provide the basis for impairment where an asset's recoverable amount is considered.
- 22 The paper states that individual input assets measured at current prices in the markets in which they would be acquired will reflect the markets' evaluations of any changes (upward or downward) in their abilities to contribute to the generation of future cash flows. The paper concludes that there would, therefore, be no need for any impairment adjustments to these market values (paragraph 116 of the paper).
- 23 We disagree with this conclusion. We note, for example, that the paper explains that there appear to be serious discontinuities between new and used car and truck market prices, which might be due to information asymmetry (paragraphs 85 and I1 of the paper). The paper seems to be concerned about the fact that a used car will be measured at too low an amount (see appendix 1 of the paper). We are, however, also concerned that the model will result in a newly acquired input asset, for which there is a Current Market Value in the market where the entity acquires the asset, to be measured at too high an amount if the entity cannot sell this item in the same market because of information asymmetry.
- 24 We also note that it follows from the paper that a self-constructed input asset should be measured at the sum of the current market prices on the measurement date of the individual inputs that comprise it (paragraph 57 of the paper). We therefore think that even in cases where individual input assets are measured at Current Market Value in accordance with the model proposed in the paper, there may be a need to adjust these values as the recoverable amount of what is constructed from input assets may be less than the Current Market Value of the individual input assets.

A price that reflects the relative economic efficiency and effectiveness of competing alternatives to the asset or liability as a consequence of incorporating publicly available information

- 25 The paper reflects the view that financial statement information should be useful for assessing the quality of management's stewardship (paragraph 15 of the paper). EFRAG agrees with this. However, as explained below, we do not consider that the model proposed in the paper always results in relevant competing alternatives being reflected. We consider that the model sometimes will depict scenarios that do not reflect how a particular entity is generating its cash flows, and in some cases are even impossible for the management to achieve. In our view such an outcome is not useful when assessing stewardship.

¹ See for example Lafond, R and Watts, R.L. "Informational Role of Conservatism", *The Accounting Review* 83 (2), 447-478.

- 26 EFRAG considered a hypothetical example of an entity that is producing aged cheese [see Example 2 of Appendix 3]. We understand that the model requires cheese that is ageing to be measured at the current market price of the amount of milk used to produce the cheese. The measurement should be updated continuously until the cheese is sold.
- 27 Accordingly, if the market price of milk goes up during the aging of the cheese, the cheese will be measured at a higher amount in the balance sheet, although the cheese cannot be converted back to milk and the entity could not purchase the milk at the current price at the balance sheet date to produce a cheese with the age of the cheese being measured.
- 28 In the income statement a gain will be reported when the market price of milk goes up although the entity does not hold milk but rather a cheese which price may not correlate with the increase in the milk price after the start of production of the cheese. When the cheese is sold, however, a lower profit margin will be reported as the 'cost' of the cheese has increased by the increase in the price of the milk after the entity purchased the milk.
- 29 In the example, we do not think that it is relevant to consider the current market price of the amount of milk used to produce the cheese when assessing stewardship. The entity is not generating its cash flows from buying and selling milk at the right time, but from producing cheese. In addition, it would be impossible for the entity to buy the milk on the measurement date and instantaneously convert this into an aged cheese.
- 30 We note that the paper does not deal with presentation, and we acknowledge that the effect from price changes on input assets could be specified on the face of the income statement and in the balance sheet. However, we do not think this would change the effects explained.
- 31 It therefore follows from the paragraphs above that EFRAG disagrees with the paper when it explains that the difference between an input asset's transaction price and its current price in the market in which it was acquired represents an 'opportunity cost or saving' (paragraph D8 of the paper). In the case with the cheese, we only think the current market value of milk represents an opportunity costs at the time the process of making a cheese is initiated. In subsequent periods, alternative use of an aging cheese represents the management's opportunities.
- 32 Although we disagree that measurement at Current Market Value will *always* provide the best information for assessing stewardship, it does not mean that the measurement will *never* provide the most useful information about stewardship. Measurement at Current Market Value may, for example, provide the most useful information for some inventories of raw materials when an entity's purchasing efficiency is an important performance driver.

An expectation of possible variations in the amounts and/or timing of future economic benefits or sacrifices (reflecting expected value probabilities that take into account all perceived possible outcomes).

- 33 The paper considers that a measure reflecting 'expected value probabilities' taking into account all perceived possible outcomes will result in the most useful information. EFRAG does not think this would always be the case.
- 34 For example, if an entity in measuring a provision estimates that there is a 99% probability to pay CU1,000 and a 1% probability to pay CU100,000. EFRAG

considers that as the objective is to provide information useful for estimating future cash outflows, the outcome of CU1,000 should be used as a measurement basis because it is overwhelmingly likely to occur. EFRAG does not think that using the expected value of CU1,990 conveys decision-useful information. In EFRAG's view, providing suitable disclosure about low probability events is more useful than trying to reflect information about such uncertainty by adjusting the measurement of the liability. We note that this approach would not result in more note disclosures as application of the expected value method would require disclosures about the assumptions made when applying the method.

A price that is independent of the private expectations and intentions of individual entities.

- 35 The paper explains that the Current Market Value of an asset or liability is independent of the private expectations and intentions of individual entities (paragraph 28 of the paper). It is argued that this result in the most useful information (paragraph B15 of the paper). We do not agree that this is always the case to the extent that private expectations and intentions reflect a documented past business practice. We think that the economic role of assets and liabilities is important to consider in relation to measurement. It may therefore be useful for one entity that generates its cash flows from holding and selling these assets and liabilities to measure these assets and liabilities differently from another entity that is transforming the assets and liabilities.
- 36 Furthermore, we do not think that the model proposed will always result in information that is independent from the private expectations and intentions of an entity.
- 37 The following paragraphs will further explain our views.

Not always useful that a measurement is independent of private expectations and intention of individual entities

- 38 According to the paper “[t]he ‘business model’ argument for measuring loan assets at amortized cost is essentially that the business model of banks and possibly other lending institutions is not designed to manage interest price change risk but is focused only on credit risk and recoverability of amounts loaned. The response of this paper is that, whether or not they choose to manage interest rate risk, their business model (the process of extending loans at fixed interest rates) exposes them to this risk. In other words, a business model is defined by what a business process actually is and encompasses all its risks; it is not defined by management’s professed intuition to limit its management of some of the risks of its business process” (paragraph M7 of the paper).
- 39 While EFRAG agrees that the effects of changes in the market rates of interest demanded in the market is decision-useful, EFRAG does not consider that this information is always the most important. In some circumstances, for example, the most essential information for assessing stewardship and predicting future cash flows in a lending arrangement may be for the profit or loss to reflect interest margins and whether these cover the costs of the lending activity (when the bank is transferring a service to its customer rather than a financial good). Although the market information may be useful it may be most useful only to place this information in the notes and let the financial statements reflect the vital information on how an entity is generating its cash flows.

- 40 Another case, where EFRAG does not agree that it would provide the most useful information to disregard established practice of an entity, relates to the measurement of provisions.
- 41 According to the paper, business operating liabilities should be measured at current prices in the markets in which the liabilities were issued or incurred (unless the prices in the markets in which they can be settled prior to maturity are lower and these prices could be achieved without additional cost to the entity (other than transaction costs)) (paragraphs 93 and 101 of the paper).
- 42 An implication of this is that when measuring onerous contracts or provisions (e.g. a service to perform an environmental restoration), the estimate shall include the margin that another entity would require to undertake the service (paragraph 99 of the paper).
- 43 Absent other evidence, we consider that if the entity that has recognised the provision has a past practice of for example performing environmental restorations itself and also plans to do this in the future, measurement that reflects this practice is most useful for predicting the future cash flows.
- 44 We acknowledge that the rationale in the paper for always including the profit margin when measuring provisions is that the measurement should not anticipate the profit margin from an entity's expected future provision of services until such time as that profit has been achieved (paragraph 99 of the paper). It could thus be argued that excluding profit margins when measuring provisions would be similar to including expected profit margins on inventory. However, we think there is a difference. In our view an entity is generating its cash flows (and revenue) when transforming inventory into finished goods (or whatever it is doing to generate cash inflows). This is different from the situation where future cash-outflows are only related with costs.
- 45 We also note that when a profit margin is included in the measurement of a provision, the entity will settle by itself, the profit in the period in which the liability is recognised will be reduced by more than if only the costs were provided. These extra costs would be 'released' and result in a profit when the liability is settled in a future period. EFRAG believes that such accounting creates inappropriate performance information as it would result in entities creating profit by settling liabilities related to themselves.

Model does not result in information that is independent of private expectations and intentions of an entity

- 46 We do not think that the measurement model proposed in the paper will always result in self-constructed assets being measured at an amount that is independent of an entities intentions even when the Current Market Value of the input assets are practicable of faithful representation.
- 47 One example is where an input asset is split or results in a by-product. If an entity, for example, is buying fish to produce fish fingers, and the Current Market Value of fish is practicable of faithful representation, we understand that the model proposed in the paper will result in the value of the produced, but not yet sold, fish fingers to be based on the Current Market Value of the amount of fish used to produce the fish fingers. However, we assume that the amount fish used to produce the fish fingers will depend on:
- (a) the relative proportion of the fish that the entity is able to use for its fish fingers; and

- (b) whether the entity is able and wants to use the remaining part of the fish for by-products such as ingredients to pet food.
- 48 Consequently, if the entity is able to utilise 90 percent of a fish for its fish fingers, the change in the price of one kilo of fish by CU1 would affect the price of one kilo of the fish fingers by CU1.1. On the other hand, we expect that the model proposed in the paper would result in the price of the fish fingers being less affected if the entity has the practice of producing ingredients for pet food from the remaining 10 percent of the fish.
- 49 Another example is the fact that the model proposed in the paper requires distinction to be made between operating, investing and financing assets and liabilities. This distinction will depend on private expectations and intentions of individual entities.

Measurement of an asset or liability should be practicable of faithful representation

- 50 The paper proposes that to be a faithful representation, measurement for financial reporting purposes should be capable of reasonable substantiation of their faithful representation on the basis that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation (paragraph 40 of the paper).
- 51 The view presented in the paper is that no amount of disclosure can compensate for the unavailability of information that is essential to representing the fundamental properties of a measurement basis. For example, the paper would not accept an estimate to be faithful representation of Current Market Value when that estimate is based only on the private expectations of the reporting entity that cannot be substantiated by observable market-relevant evidence (see paragraph A13 of the paper).
- 52 According to the paper, if the Current Market Value of an asset or liability is not practicable of faithful representation, the most relevant substitute that is practicable of faithful representation should be used when measuring this asset or liability. The most relevant substitute is the one that most nearly embodies the properties of Current Market Value (see paragraph 2 above).
- 53 Whether an item has a Current Market Value that is practicable of faithful representation is also relevant when considering whether the market value created by a cash-generating process (revenue) should be recognised (see paragraph 3 above).
- 54 Our views on the concept of 'practicable of faithful representation' in relation to measurement and revenue recognition are included in the following paragraphs.

'Practicable of faithful representation' in relation to measurement

- 55 EFRAG agrees that the concepts of 'practicability' and 'faithful representation' as explained in the paper are appropriate in relation to measurement.
- 56 It appears from the paper that 'practicability' is intended to capture the cost constraint on useful financial reporting included in the current Conceptual Framework. We agree with this constraint.
- 57 The paper explains that 'faithful representation' may have another meaning in the paper than in the current Conceptual Framework. We agree with this and think that

the paper therefore should have used another term in order to avoid confusion. If the intention of the proposal is to change how 'faithful representation' is defined in the Conceptual Framework, we would disagree with this proposal. Although we agree with the paper that measurement for financial reporting purposes should be capable of reasonable substantiation, we also think that disclosures should be considered when assessing whether an economic phenomena is faithfully represented. That is, we do not think disclosures can compensate for large margins of errors in measurement. On the other hand we think that in some cases it may be necessary to provide disclosures in relation to verifiable figures in order to achieve a faithful representation (see for example paragraph 34 above).

'Practicable of faithful representation' in relation to revenue recognition

- 58 As explained in EFRAG's comment letters in response to the IASB's exposure drafts on revenue recognition, EFRAG considers revenue to be a measure of the establishment of an irrevocable right to consideration, subject to continued performance, that arises as the entity fulfils a contract with a customer.
- 59 We consider that our proposed principles for revenue recognition would often, but not always, be in accordance with the concepts for revenue recognition developed in the paper.

A way forward

- 60 EFRAG thinks that the role of a measurement framework should first be to identify the properties of relevant measurement bases. Directions on when certain properties would be particularly important should then be provided to help standard setters in choosing the best measurement bases. The directions should be based on financial statement users' needs and should include an assessment of how the properties would result in useful depictions of both an entity's performance and financial position.
- 61 EFRAG does not believe that it will be possible to identify one ideal measurement basis. Our comments above illustrate, for example, that we do not assess that Current Market Value as defined in the paper would always provide the most useful information (even when Current Market Value is practicable of faithful representation). However, the paper will be useful in the work of identifying the properties of Current Market Value (and other measurement bases).
- 62 Absent detailed knowledge on the use of financial statements, EFRAG believes that financial statement information is most relevant, if it reflects how an entity has generated its cash flows. Some entities are, for example, generating cash flows from holding and selling particular assets. For these entities information about holding gains and losses may be relevant. Other entities are generating cash flows from transforming input assets into something else. For these entities information about holding gains and losses may be irrelevant.
- 63 The paper seems to acknowledge that some businesses are about transforming input assets to output assets (see for example the depiction of business operating activities in paragraph 33 of the paper). However, at the same time the paper proposes that it is always relevant to include holding gains and losses on input assets in the income statement for the period. As explained above we disagree with this.
- 64 We also explained above that we think financial statement information is most relevant, if it is linked with actual cash flows, and we agree with the paper that

financial statement information should not only be useful for estimating future cash flows but also for assessing stewardship.

- 65 A measurement framework should, however, do more than identifying properties of relevant measurement bases and provide directions on when certain properties are particular important. In our view a measurement framework should also provide directions on how to deal with situations where the ideal measurement basis is not practicable of faithful representation. We agree with the paper, that in such circumstances, the most relevant alternative measurement basis that is practicable of faithful representation should be found. However, we do not think this will be an easy task and contrary to the paper, which leaves the issue for the development of specific standards, we think a framework should provide directions on this issue. In this regard, we also note the discussion about market efficiency included in the paper (appendix B of the paper), and remind that directions should also be provided for measures that refer to a price in a market, when there is evidence that the current market price does not reflect the properties associated with the measure.
- 66 When providing direction on measurement bases and relevant substitutes, we think that it is important not to consider measurement of various assets and liabilities in isolation. Our concern about considering measurement in isolation can be illustrated by means the model proposed in the paper. We think, for example, it would provide confusing information if the input assets in the ship construction example in paragraphs 13 to 16 above would be measured at Current Market Value while the performance obligation to construct the ship would be measured at something else (likely the price agreed when the contract was entered) because its Current Market Value would not be practicable of faithful representation. The effect would be that when revenue is recognised, it will be on the basis of the agreed contracted amounts while the costs of goods sold would reflect the Current Market Values of the input assets. Accordingly, if the prices of input assets are increasing, the entity may report a profit from the increase in the price of the input assets during the construction, but a loss when the good is finalised. This would reflect that the entity in the example is not generating profit from its production which we think is a wrong reflection.
- 67 EFRAG would also propose the 'unit of account' to be considered and described in a framework for measurement, in order to provide directions for standard setters. The impairment test of the paper highlights this need. For example, we think 'individual input asset level' could be interpreted very differently in relation to impairment of self-constructed inputs unless it is described how to determine the borders of a self-constructed input assets (in case of a shipyard is the asset to be considered: a part of a ship, one ship or a group of ships (that are sold together)). Although the framework should provide directions on the issue, the unit of account should still be further specified at standard level.
- 68 Finally, we think that a conceptual framework for measurement should work for all entities. In this respect we note that we found it difficult to apply the distinction between operating, financing and investing activities to financial institutions such as banks and insurance companies.

APPENDIX 2 – Link to the questions raised in the paper

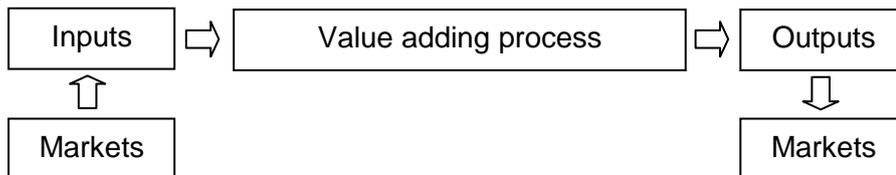
The paper includes eight questions. In order to facilitate comments from constituents on EFRAG’s draft comment letter, EFRAG has decided not to structure its draft comment letter in the order of these questions. The table below shows how the paragraphs in EFRAG’s draft comment letter are linked to the questions raised in the paper.

Question	Paragraphs
1	3, 4, 6, 8 - 49.
2	50 - 59.
3	11 - 19, 25 - 32, 46 - 49, 55 - 57.
4	33, 34, 40 - 45.
5	38, 39, 49.
6	20 - 24.
7	No paragraph relates to this question – EFRAG refers to its discussion paper <i>A Disclosure Framework for the notes to the financial statements</i> .
8	No paragraph relates to this question.

APPENDIX 3 – High level notes for constituents

1 The paper proposes that Current Market Value is the ideal (most relevant) measure of assets and liabilities for financial reporting purposes. According to the paper, the reason is that Current Market Value of an asset or liability embodies seven properties and that other identified measurement bases lack one or more of these properties, and do not have any additional more relevant properties. Other measurement bases may, however, be evaluated as possible substitutes when current market value is not practicable of faithful representation.

2 The paper conceptualises business operating activities as follows:



3 The paper proposes that market value created by a cash-generating process (revenue) should be recognised when the process (1) has achieved an output that has a Current Market Value that is practicable of faithful representation, and (2) has generated the good and/or service that is the source of that output market value.

4 It is deduced from this that assets that are inputs to entity cash-generating processes should be measured at their current market prices in the markets in which they would be acquired, or when such prices are not practicable of faithful representation, on the basis of the closest (most relevant) substitutes for these current market values that are practicable of faithful representation. This means that there should be no recognition of any value added as a result of combining inputs to construct an input asset. The current market value of a self-constructed input asset is, according to the paper, the sum of the current market values on the measurement date of the individual inputs that comprise it.

5 Investing and financing assets and liabilities should be measured at current prices in the markets in which they were acquired, issued or incurred if such prices practicable of faithful representation. Changes in Current Market Values should be immediately reported in the statement of income.

6 The paper proposes that no adjustment for impairment is required for individual input assets measured at current prices in the markets in which they would be acquired. However, an input asset accounted for on the basis of a cost-based substitute will require a provision for impairment. The paper proposes an impairment test at the level of the cash-generating unit. According to this test, the sum of the carrying amount of business operating assets (less liabilities) comprising a cash-generating unit should not exceed the current market value of that cash-generating unit or, if that market value is not practicable of faithful representation, of a current value substitute that is practicable of faithful representation.

Examples

7 The paragraphs below illustrate the effects of the proposals of the paper by providing three examples. It is assumed in the examples that Current Market Value is practicable of faithful representation.

Example 1 – Gold Jewellery Manufacturing

Toward a Measurement Framework for Financial Reporting by Profit-Oriented Entities

An entity is manufacturing 24 carat gold jewellery. It holds inventory of gold and of unsold manufactured jewellery (of gold). Assume that there is no waste when producing the jewellery. The table below provides some information about the situations at the end of Period 0 (P0), Period 1 (P1) and Period 2 (P2).

	P0		P1		P2	
	kg	CU/kg	kg	CU/kg	kg	CU/kg
Gold purchased			4	30,000	3	43,000
Gold used in manufacturing			5		6	
Gold inventory	5	32,000	4		1	
Sold jewellery			5		5	
Jewellery inventory	1		1		2	

- 8 Assume that the activities related to gold purchases, manufacturing and the sale of jewellery all take place at the end of each period. If the average sales price at the end of P1 of each kg of jewellery is CU122,000 and CU142,000 in P2, the income statement will be as follows when the proposals of the paper are applied:

	P1	P2
Revenue	610,000 ¹	710,000
Cost of goods sold	150,000 ²	215,000
	460,000	495,000
Gains (losses) on:		
Gold inventory	(10,000) ³	52,000
Jewellery inventory	(2,000) ⁴	13,000
Total effect on income	448,000	560,000

Note that the paper does not consider how the figures should be presented – they could therefore be presented differently.

1: 5 kg * CU122,000 per kg

2: 5 kg * CU30,000 per kg

3: 5 kg * (CU30,000 – 32,000) per kg

4: 1 kg * (CU30,000 – 32,000) per kg

Example 2 – Cheese producer

- 9 An entity is producing a particular cheese. It takes two periods to produce such a cheese. Assume that the only significant input to the cheese is milk. The entity does not have any inventory of milk. The prices of milk (to produce one cheese) and of the cheese produced are shown below.

Toward a Measurement Framework for Financial Reporting by Profit-Oriented Entities

	P0	P1	P2	P3
Milk price	1.0	2.0	3.0	2.0
Cheese price	3.5	3.5	4.0	4.0

- 10 The entity starts producing one cheese in P0 that it sells in P2 and it is commencing the production of another cheese in P1 that it sells in P3.
- 11 If the entity would measure the milk at historical cost, the following income statement would result:

	P0	P1	P2	P3
Revenue			4.0 ¹	4.0
Cost of goods sold			1.0 ²	2.0
Total effect on income			3.0	2.0

1: 1 cheese * CU4.0 per cheese.

2: Price of milk for one cheese in P0.

- 12 When applying the proposals of the paper, the income statement would be as follows (assuming that Current Market Value is practicable of faithful representation):

	P0	P1	P2	P3
Revenue			4.0 ¹	4.0
Cost of sold			3.0 ²	2.0
Subtotal			1.0	2.0
Input price gains or losses		1.0	2.0 ³	(1.0)
Total effect on income		1.0	3.0	1.0

Note that the paper does not consider how the figures should be presented – they could therefore be presented differently.

1: 1 cheese * CU4.0 per cheese.

2: Price of milk for one cheese in P2.

3: In P2 two cheeses are under production, the price of milk to produce one cheese has increased by CU1.

Example 3 – Shipyard

- 13 An entity is producing ships. It takes 3 periods to produce a ship. Assume that the only input is labour and steel. The price of a ship depends on the steel price. The shipyard only starts building a ship when it has received an order. The shipyard receives an order at the end of P0. Based on the steel price at that time it is agreed that the price of the ship (Ship 1) is CU18. At the end of P1, the shipyard receives another order for Ship 2. The price CU30 is agreed (the price on Ship 2 is higher than the price of Ship 1 as the steel price has increased between P0 and

Toward a Measurement Framework for Financial Reporting by Profit-Oriented Entities

P1). When the shipyard receives an order it purchases the steel necessary to construct the ordered ship. Assume that 1/3 of a ship is constructed in a period and that labour and steel is appropriated to the construction at the end of each period.

- 14 The ship, steel and labour prices to construct a ship are as follows:

	P0	P1	P2	P3	P4
Steel price	10	20	30	20	25
Labour price	2	3	4	5	6
Current Market Value of performance obligation	18	30	54	38	47

- 15 If the revenue recognition criteria proposed in the paper are applied but input assets are measured at historical cost, revenue and costs would be reported as follows when the criteria for revenue recognition are only met when a ship is completed:

	P0	P1	P2	P3	P4
Revenue				18 ¹	30
Cost of goods sold				14 ²	25
Total effect on income				4	5

1: Price agreed when the ship is ordered

2: Cost of steel in P0 (CU10) plus price of labour in P1, P2 and P3 ((CU3+CU4+CU5)/3)

- 16 According to the proposals of the paper, and assuming that labour is to be considered as an input asset, incomes and costs would be reported as follows when the criteria for revenue recognition are only met when the contract is completed:

	P0	P1	P2	P3	P4
Revenue				38.0 ¹	47.0
Cost of goods sold				25.0 ²	31.0
Subtotal				13.0	16.0
Input price gains or losses		10.0	20.3	(19.0) ³	5.7
Gains or losses on performance obligations		(12.0)	(48.0)	32.0 ⁴	(9.0)
Total effect on income		(2.0)	(27.7)	26.0	12.7

Note that the paper does not consider how the figures should be presented – they could therefore be presented differently.

Toward a Measurement Framework for Financial Reporting by Profit-Oriented Entities

1: The Current Market Value of the performance obligation to construct a ship at P3.

2: Steel price and labour price at the time the ship is finalised (CU20 + CU5).

3: At the end of P2, Ship 1 is completed by 2/3, accordingly, there is a holding gain on 2/3 of the increase in the price of labour ($2/3 * (CU5 - CU4) = CU0.7$). The steel needed to construct Ship 1 is either included in the construction or in the raw material inventory. The holding gain/(loss) from P2 on the steel for Ship 1 is therefore $CU20 - CU30 = (CU10)$. At the end of P2, Ship 2 is completed by 1/3, accordingly, there is a holding gain on 1/3 of the increase in the price of labour ($1/3 * (CU5 - CU4) = CU0.3$). The steel needed to construct Ship 2 is either included in the construction or in the raw material inventory. The holding gain/(loss) from P2 on the steel for Ship 2 is therefore $CU20 - CU30 = (CU10)$. In total the holding gain/(loss) is $CU0.7 - CU10 + CU0.3 - CU10$.

4: At the end of P2 the market price to have a ship (like Ship 1 and Ship 2) constructed is CU54. In P3 the price has fallen to CU38. This thus reduced the liabilities to construct the ships by $2*(CU54 - CU38)$.

- 17 If the revenue recognition criteria proposed in the paper are applied but input assets are measured at historical cost, revenue and costs would be reported as follows when the revenue recognition criteria are met as the ships are constructed:

	P0	P1	P2	P3	P4
Revenue		6.0 ¹	16.0	16.0	10.0
Cost of goods sold		4.3 ²	12.7	13.3	8.7
Total effect on income		1.7	3.3	2.7	1.3

1: At the end of P1, Ship 1 is completed by 1/3. Accordingly 1/3 of the agreed price of CU18 is recognised as revenue.

2: The price of the steel acquired to construct Ship 1 was CU10. 1/3 of this is used to construct 1/3 of the ship. The price of the labour to construct 1/3 of Ship 1 in P1 is $1/3 * CU3$.

18 According to the proposals of the paper, the following could be reported:

	P0	P1	P2	P3	P4
Revenue		10.0 ¹	36.0	25.3	15.7
Cost of goods sold		7.7 ²	22.7	16.7	10.3
Subtotal		2.3	13.3	8.7	5.3
Input price gains or losses		10.0 ³	16.7 ³	(10.0)	1.7
Gains or losses on performance obligations		(12.0) ⁴	(40.0) ⁴	16.0	(3.0)
Total effect on income		0.3	(10.0)	14.7	4.0

Note that the paper does not consider how the figures should be presented – they could therefore be presented differently.

1: At the end of P1, Ship 1 is completed by 1/3. Accordingly 1/3 of the Current Market Value (CU30) for a similar contract is recognised as revenue (it is assumed that Principle 1 of the paper is met for this 1/3).

2: To construct 1/3 of Ship 1, 1/3 of the steel to construct one ship and 1/3 of the labour to construct one ship is utilised. At the current price at the end of P1 that is $1/3*(CU20 + CU3)$.

3: At the end of P0 no work has been performed on neither Ship 1 nor Ship 2. The only holding gain is the gain on the steel purchased to construct Ship 1. This holding gain is calculated just before revenue and cost of revenue is recognised, as part of the inventory has been utilised to complete 1/3 of Ship 1 in P1. In P2, the holding gain consists of the increase in the price of the steel purchased for Ship 2 (CU30 – CU20). In addition there is a holding gain of 2/3 (the part that has not yet been recognised as cost of revenue) of the increase in the steel price for the steel purchased for Ship 1 ($2/3 * (CU30 - CU20)$).

4: In P0, the obligation to perform Ship 1 is completely unfulfilled. The Current Market Value of the performance obligation increases by CU12 from P0 to P1. At the end of P1 1/3 of the obligation to construct Ship 1 has been fulfilled. The increase in the Current Market Value from CU30 to CU54 therefore only affects the income statement with $2/3*(CU54 - CU30) = CU16$ for Ship 1. At the end of P1, the obligation to perform Ship 2 is completely unfulfilled. The Current Market Value of the performance obligation increases by $(CU54 - CU30) = CU24$ from P1 to P2.

19 As noted, the paper does not suggest how to present the figures. An alternative method could be to present the figures as follows:

Toward a Measurement Framework for Financial Reporting by Profit-Oriented Entities

	P0	P1	P2	P3	P4
Revenue as contracted		6.0	16.0	16.0	10.0
Current price adjustments		4.0	20.0	9.3	5.7
Total revenue at current prices		10.0	36.0	25.3	15.7
Cost of goods sold at current prices		7.7	22.7	16.7	10.3
Current operating profit		2.3	13.3	8.7	5.3
Input asset price gains or (losses)		10.0	16.7	(10.0)	1.7
Gains or (losses) on performance obligations		(12.0)	(40.0)	16.0	(3.0)
Net income from operating activities		0.3	(10.0)	14.7	4.0