EFRAG ACADEMIC WORKSHOP

SUMMARY REPORT

5 SEPTEMBER 2017

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Introduction

EFRAG organised an academic workshop event in Brussels, Belgium on 5 September 2017 around various aspects of measurement in financial reporting. The objective of the workshop was to debate ideas on some of the main issues around measurement (e.g. uncertainty and discounting) and how these can be investigated.

Jean-Paul Gauzès (EFRAG Board President) opened the event and welcomed the participants. Thereafter, Günther Gebhardt (EFRAG Academic Panel Chairman) outlined that the debate should focus on the issues around the Conceptual Framework for Financial Reporting (CF) and in particular measurement which was initially omitted from the proposed CF.

Presentations and discussions

General discussion on measurement

In the first session, the discussion focused on what the objectives of measurement in financial reporting should be. Participants were also asked if, beyond the traditional objectives of assisting users to predict future cash flows and assessing stewardship, other aspects should be considered, such as societal and wider economic impacts.

Participants replied that before deciding on what the objectives of measurement in financial reporting should be and how measurement base should be selected, it was necessary to establish what financial statements should depict.

Financial statements are used in different contractual settings. Different types of users with different skills would have different information needs. In addition, the context – including national settings – could influence the role of, among other things, uncertainty and the effects of information asymmetry.

Financial statements can, for example, be used by different types of investors to make investment decisions or to assess the management respectively. These different types of use might require different types of information. It could be that for assessing the management, only changes in assets values driven by managerial behaviour should be reported while other changes in the value of assets should be reported for making decisions about investing in the entity.

Standards that would take the different needs of the users into account could be complex to prepare as the different needs could be conflicting. In such cases, the focus could be on providing the information in the financial statements that would or could not be provided to the same extent through other sources – that is, focusing on the “competitive advantages” of financial statements. Some of the competitive advantages of financial statements include:

- Financial statements include “bad news” which could offset the good news the management of an entity would communicate through other sources.
- Financial statements are focused on facts rather than wishful thinking.
- The information included in the financial statements does not include too much measurement uncertainty.

Research has shown that for contractual purposes, calculations of financial figures of an entity is frequently tailor made. This could indicate that general purpose financial statements are not considered to always provide the most useful information for contractual purposes.

General decisions on the objectives of financial statements would, however, not immediately point to the use of a particular measurement bases. For example, if the objective of financial statements should be a tool to assess management, it would not be certain whether it would result in another measurement bases than an objective to provide information useful for investment decisions. The information necessary for assessing the management would depend on what the management could be considered to be responsible for. A presumption that the assessment of management's stewardship would generally result in backward-looking information cannot be made. Information about decisions of the management that could introduce volatility and/or high risks in the future could be relevant for the assessment of stewardship. Similarly, it cannot generally be concluded that measurement at either fair value or historical cost would be most useful for assessing stewardship or that fair value will always result in more relevant and neutral information and measurement at historical cost will result in more reliable and conservative information.

Some participants in the workshop thought that when deciding on the measurement bases to use, the entity's business model could be considered. Assets and liabilities could have different values for different entities as the economic possibilities between entities are different because of market frictions. The business model is also considered in current IFRS. The business model should, however, not be used as an excuse by entities to do what they want and it could be difficult to define what exactly is meant by the term 'business model'. An argument against reflecting the entity's business model in the selection of a measurement basis could be that the financial statements would not reflect if an asset could be used in a more profitable manner than how it is used by the entity.

The choice of a measurement basis would have real economic effects (i.e. effect on the distribution of wealth in society). However, it could be difficult to take these effects into account when setting standards as: (1) It would be difficult to take all the factors into account (2) The consequences would be different from country to country (3) It would require decisions about how wealth should be redistributed.

One type of research that could provide more information on how measurement bases should be selected when setting standards would include research investigating how financial statement information is used.

Discounting

In this session, the discussion addressed what is the purpose of discounting and how risk should be incorporated in determining discount rates.

It was noted that present value is not a measurement objective *per se* but a technique to achieve an objective. It is therefore important to clearly define objectives to avoid inconsistent requirements. The rate should be designated to achieve the objective of the measurement. For instance, to achieve a fair value measurement the rate should incorporate the risks that a market participant would consider in pricing the item.

Present values can provide useful information in conditions of low uncertainty and when an internal rate of return is available.

Discount rates reflect two elements, the time value of money and the risks associated with the asset or liability. When discounting liabilities, the question arises on the treatment of the issuer's own credit risk, that is the risk that an entity will fail to discharge its own obligations. A risk-free rate could be more appropriate.

The Standards should provide a clear description of the risks that need to be included in a certain measurement. Risks may be financial as well as non-financial in nature. A non-financial risk cannot be matched by a portfolio of assets; therefore, it would increase the volatility of the potential outflows of an obligation and the value of a liability. It may be necessary to provide information on the variability of the outcomes.

Risks may need to be addressed differently in market-based measures and measurement based on internal input such as values in use. There must be consistency between the inputs in each method. Financial economics studies should be considered to develop proper measurement requirements for risk premiums in accounting.

Another issue about the treatment of risk is that Standards allow to incorporate it either in the estimated cash flows or the discount rate; as a consequence, the impact can be presented alternatively as an operating cost or interest cost, and affects widely used ratios like EBITDA.

Uncertainty in measurement

In this session, the discussion focused on diverse types of uncertainty and how they should be reflected by the measurement attributes.

Without uncertainty, there would be no role for accounting. However, users of financial statements are not embracing volatility in the financial statements. Based on interviews of some users, it seems as if:

- Although users want to be informed about risk (and hence that financial statements would reflect volatility), so the risk could be dealt with, risk and volatility would make the work of investors more complicated. The reason is that investors would have to manage the risk in their portfolios.
- Users are concerned about complex accounting requirements resulting in volatility that is not understood by the users.

Conditionality and uncertainty affect a range of transactions and items. They could be incorporated either in the recognition criteria or measurement.

Current IFRS is not consistent on whether to use an expected value approach or a most likely approach when measuring uncertain outcomes. One perceived weakness of using an expected value approach is that the reported value would almost never reflect the actual future cash flows. On the other hand, it could also be argued that:

- The purpose of financial statements is not to provide an estimate of actual future cash flows – but to provide information to enable users of financial statements to make such projections. Accordingly, the financial statements should depict the estimated value of

assets and liabilities at the balance sheet date – and not the ultimate cash flows resulting from them.

- In practice, it would often be difficult to assign probabilities to various possible outcomes. In cases with many potential outcomes, a single outcome with a slightly higher assigned probability than other outcomes, would seldom reflect the actual future cash flows. In such cases it could be more sensible to calculate the average of a range of possible outcomes.
- In some cases, very different outcomes could have similar probabilities of occurring. The outcome of using a most likely approach could therefore vary significantly based on small margins when estimating the probabilities related to different possible outcomes.

In any case there are limitations to each method, so a single number will not provide the full information and needs to be supplemented. Accounting should provide the information to enable market participants to make their own predictions. Ideally, to prevent information overload, financial statements should only provide information about material risks and volatility. In practice, however, entities might provide too much information about immaterial risks as they would try to avoid litigations resulting from providing too little information.

There may be a need to treat differently uncertainty when management has a degree of control on the events that affect the future cash flows, as well as to make a distinction between reversible and irreversible uncertainty.

Future research on uncertainty in measurement could include experiments designed to investigate whether some groups of users find prudence more useful than other groups. Normative accounting literature suggests that prudence may be considered more relevant for debtholders than equity investors. Debtholders are only interested in the financial position of an entity to the point where they are sufficiently confident that they can recover the principal and interests. On the other hand, analytical research seems inconclusive about whether prudence is good or not for debtholders. That research indicates that the signal effect that could lead to revision of expectations and make predictions more precise is key to investors.

Entity or market perspective

In this session, the discussion addressed whether the measurement should reflect the perspective of a generic market participant or that of the specific entity. Participants considered a business combination where the acquirer would take over an entity with a brand that the acquirer does not intend to use in the future.

At the workshop, the argument was presented that at initial recognition, this brand should be recognised in the consolidated financial statements. The management's intention should not affect the initial measurement. However, if the brand was not going to be used by the acquirer, a day two impairment loss might have to be recognised. The relevant initial measurement of the brand should reflect what the entity could do with the brand (which is different from the management's intention). Because of market frictions, entities have different opportunities which should be reflected in the measurement of assets and liabilities.

Another argument presented was that the measurement should be based on the valuation model used for valuing the entity.

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Closing remarks

Günther Gebhardt thanked the speakers and participants for their contributions and closed the event.

Participants

Jean-Paul Gauzès	EFRAG Board President
Günther Gebhardt	EFRAG Academic Panel Chairman
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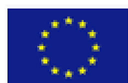
This summary report reflects views expressed by the various participants in the workshop. The individual participant may accordingly have other views than those expressed in this report.



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