Exposure Draft 76

"Conceptual Framework Update: Chapter 7, *Measurement of Assets and Liabilities in Financial Statements*"
REQUEST FOR COMMENTS

Task force IRSPM A&A SIG, CIGAR Network, EGPA PSG XII

October 21st, 2021

The IPSASB has requested comments and answers to specific questions regarding ED 76. The objective of the project is to update Chapter 7 of the IPSASB's Conceptual Framework in order to provide more detailed guidance on the application of the commonly used measurement bases in IPSAS and in order the strengthen coherence between the Framework and the standards.

The comments and responses prepared by the Task Force IRSPM A&A SIG, CIGAR Network and EGPA PSG XII are presented below. The IRSPM A&A SIG, CIGAR Network and EGPA PSG XII are three research networks that focus on Public Sector Accounting. The Task Force is made up of 17 researchers from these networks. The views expressed in this document represent those of the members of the Task Force and not of the whole research community represented by the networks, and neither of the Institutions/Universities with which they are affiliated.

CORE ASSUMPTIONS

We are of the opinion that, in general, public sector entities require public sector specific principles and standards that properly accommodate public sector specificities. As such, when public sector transactions resemble those taking place in the private sector, then principles and standards may be kept as aligned as possible. However, for public sector specific transactions, we are in favor of standards that are not adapted artificially from private sector accounting and we think there is a need to seek options that best fit the public sector. This core thesis underpins our proposals and recommendations herein.

We appreciate the opportunity to contribute to the consultation. **Our response is in three parts**. It consists of "**General Comments**", an "**Introduction to our responses to ED 76**" and the proper "**Specific Matter Comments**".

GENERAL COMMENT

The Specific Matters for Comment in the three EDs related to measurement, namely ED76, ED77 and ED 78, do not cover some broader issues which we would like to highlight. These comments apply as well to our responses to ED77 and ED78.

In our opinion, the Conceptual Framework and/or the standards should provide structured guidance to orient (and even direct) the accounting policy choice concerning accounting measurement models and subsequent measurement bases and techniques. By avoiding to provide such guidance, the IPSASB is allowing weak reporting and mismanagement.

A conceptual framework may and should provide guidance to preparers in order to choose between measurement models. The conceptual framework may even limit the choices available, according to a coherent set of consistent indications, and it should define conditions under which preparers of financial statements in the public sector may use different measurement models, providing full explanation on these motivations. While we appreciate that subjectivity is inherent in financial reporting, we point out how important it is to minimize the extent that subjectivity is required to be exercised in public sector financial reporting, due to the scope of such reports to provide accountability to the citizens.

The IPSASB should emphasize the fact that most of the physical capital goods are non-monetary items, which means that a government owning and using those goods is not the owner of monetary units, but it holds only certain rights on those capital goods. Generally speaking, these rights are such that governments have the custody rights but without having usufruct, and facing restrictions on alienation rights. The non-financial characteristics of these assets are the main cause for difficulties in applying various valuation models, bases and techniques in the public sector.

One issue that we identify is the very introduction of a current value model with several bases and techniques, without a clear view on when this model can and should be applied. We agree that its usefulness is limited generally speaking, and its misrepresentation risks rank high in some circumstances.

In our responses concerning asset measurement, we tend to favor "replacement cost" as an alternative to "current operational value" because replacement cost is quite a straightforward value to determine. In fact, both seem to tend to increase the current resource needs (that is, current costs, supposed to be covered by current revenues) by the reporting entity, which is not going to renew those resources now and is not supposed to do it soon. When renewal occurs, the entity may have recourse to other sources than operational flows and related reserves, typically debt issuance. Therefore, the use of replacement cost or current operational value does violate intergenerational equity between current and future taxpayers.

Alternatively, reference could be made to “renewal accounting” or “fixed cost depreciation method”, in which the carrying value of the asset is kept constant because of its constant service potential. Accordingly, depreciations are not booked, but efforts are made (and resources are employed) to ensure that constant service potential is maintained. Related expenditures are directly charged as expenses in the Statement of Financial Performance. This model is not considered by the IPSAS framework, despite the many potential examples, such as fire departments, libraries, health care equipment, and so forth, where a constant service potential is required.

To conclude, we highlight that, in our opinion, a standard on measurement as proposed by ED 77 is not really required. Most of the material on historical cost and current value models and related information needs, currently included in the ED 77, would be more useful if integrated with ED 76 as part of Chapter 7 update. This would make Chapter 7 of the Conceptual Framework more complete and informative. If the IPSASB keeps seeing the need to issue a separate standard on fair value, the latter being in line with IFRS 13, then the IPSASB can elaborate this separate standard on fair value without negatively impacting the format and structure of the Conceptual Framework. In fact, the utility of a separate standard on fair value in the public sector is questionable, but this latter argument is beyond the scope of this comment on the ED 76.

INTRODUCTION TO OUR RESPONSES TO ED 76

We welcome the opportunity to comment on ED 76.

The objective of ED 76 is to present a measurement hierarchy at three levels, namely, measurement models, measurement bases and measurement techniques. We would like to express our reservations about this from the outset, in that, we find the wording confounding, since readers may expect a hierarchy between measurement models, instead of an ordered taxonomy of principles, concepts and techniques for all measurement approaches. Therefore, the term "measurement taxonomy" would be more appropriate.

According to ED 76, the objective of the measurement hierarchy is to clarify the IPSAS measurement framework, as follows:

- Measurement MODELS intend to represent approaches to present assets and liabilities. There are two models – HISTORICAL COST and CURRENT VALUE.

- Measurement BASES are methods to present relevant and fairly representative information under the selected model. There are 4 bases: (i) the historical cost basis; (ii) current operational value; (iii) fair value; and (iv) cost of fulfillment. For the 4 bases identified, ED 76 describes the basis and evaluates the information they provide; then, ED 77 defines the bases and provides guidance on implementation in practice.

- Measurement TECHNIQUES are methods to estimate the amount at which an asset/liability is presented under the selected basis. There are no techniques under the historical cost model/basis. There are 3 techniques under the current value model: (i) market approach; (ii) cost approach; and (iii) income approach. Par. 7.12 states that **Guidance on measurement techniques is provided at the standards level.** The summary (At a glance) of ED 76 gives the impression that this shall be all included in ED 77 Measurement: '*ED 77 defines the measurement bases and provides separate appendices that include guidance on how the bases are implemented in practice*'. **However, ED 77 describes the approaches to make estimates, rather than the actual estimation techniques**.

We point out that the intended hierarchy is not apparent in these descriptions. For example, both measurement bases and measurement techniques are referring to 'methods'. It would be expected that a measurement model indicates the approach, the measurement basis would be the method observed under conceptual rules, while the measurement technique identifies the procedure to apply the basis.

We wish to point out that we have highlighted other issues related to ED 76 in our response to SMC 7.

Specific Matter for Comment 1:

ED 76 proposes a measurement hierarchy. Do you agree with the three-tier hierarchy? If not, why not? How would you modify it?

We agree with the underlying concept of a measurement hierarchy, however, as already stated in our General comments above, we find the terminology used in the ED 76 confusing and would prefer the term "Measurement Taxonomy". The three-tier hierarchy distinguishes between models, bases and techniques. At each level, there is no hierarchy of models, but simply several alternative options. Furthermore, these options are not ranked in order of priority.

The three-tier hierarchy can be a way of clarifying possible approaches, but this presentation should not be made strictly dominant in the way governments deal with the representation of their accounting elements into monetary terms. For instance, when certain capital goods are not recognized as assets because they do not reach certain materiality thresholds, governments can prefer "renewal accounting" systems which are not included in the three-tier hierarchy.

Measurement techniques are defined as methods to estimate the amount at which an asset/liability is presented under the selected basis. Perhaps there is an element of ambiguity in this definition because it leads one to expect these measurement techniques to include guidance on when and how to apply the various depreciation and amortization methods. But then the ED makes it clear that this is not the intention.

We would suggest a more direct definition for measurement techniques by adjusting it along these lines:

"*Measurement techniques are procedures/criteria to choose appropriate methods that estimate the amount at which an asset/liability is presented under the selected basis*".

As indicated in our responses that follow, we do not fully agree with the measurement bases chosen.

Specific Matter for Comment 2:

Do you agree with the proposed inclusion of fair value as a measurement basis for assets and liabilities with the same definition as in IFRS 13, *Fair Value Measurement*, in the Conceptual Framework? If not, why not?

'*Under the current value model, assets and liabilities are measured using information updated to reflect price changes to the measurement date*' (Par. 7.9). Fair Value Measurement is, therefore, properly categorized as a basis under this model. We agree that, if the term 'fair value' is to be used, then it should have the same meaning as that in IFRS 13, in order to foster understandability and avoid confusion. Having said this, we appreciate that ED 76 is recognizing the limitations related to fair value as a measurement basis in the public sector.

We agree with par. 7.37 '*Fair value is appropriate where the asset is being held primarily for its ability to generate economic benefits or with a view to sale'*. We also agree with par. 7.39 '*The usefulness of fair value is more questionable when the assumption that markets are orderly does not hold [Orderly market is described in par. 7.40] … fair value may not reflect the value to the entity of the asset represented by its operational capacity … fair value may not be useful for operational assets that an entity intends to continue to use for service delivery*'.

Par. 7.42 is very important, but it appears misplaced because it applies also when there is an orderly market. We suggest that this is moved to 'Financial Capacity', that is before Par. 7.45.

We also fully agree with the limited applicability of the relevance of Fair Value as expressed in Par 7.45 and Par. 7.47.

As fully explained in our general comments above, we further recommend providing guidance to preparers in order to choose between measurement models, and to choose between measurement bases under the current value model. The conceptual framework may even limit the choice according to a coherent set of indications. The fact that the current draft does not purport to provide such guidance appears to be one of its **main limitations**.

Specific Matter for Comment 3:

Do you agree with the proposed inclusion of current operational value as a measurement basis for assets in the Conceptual Framework? If not, why not? *The Exposure Draft includes an Alternative View on current operational value.*

The measurement basis Current Operational Value is defined as '*the value of an asset used to achieve the entity's service delivery objectives at the measurement date*'. The IPSASB developed it as a public sector specific measurement basis for assets held primarily for their operational capacity. Operational capacity is the capacity of an entity to support the provision of services in future periods through physical and other resources. According to ED 76, the Current Operational Value measures assets in their current use. Current use reflects the way an asset is being used by the entity, and reflects the policy objectives of the entity operating the asset. For example, a building used for the wellbeing of citizens rather than for commercial purposes.

The IPSASB's Conceptual Framework extended the definition of an asset from economic benefits it provides, to service potential that is expected to flow to the entity. However, one needs to bear in mind that the services a government produces, by using its service potential, flow to the citizens and not to the government entity; and thus, benefits from service potential by held assets, would not affect the government's net assets.

It is not clear how the Current Operational Value is a measurement basis that falls under the Current Value Model, particularly with reference to the need to reflect price changes. Par. 7.9 states that '*Under the current value model, assets and liabilities are measured using information updated **to reflect price changes** to the measurement date*'.

We express further **concerns about the Current Operational Value** as a measurement basis, as follows:

The definition of Current Operational Value is rather unclear. It would be interesting to see its application in practice. Is it another term for Value in Use or for Current Cost[1]? Clarification is required as to how the Current Operational Value basis is different from Value in Use and Current Cost. **It may be helpful to include an example that shows how Value in Use and Current Cost differ from Current Operational Value.**

Is the Current Operational Value any simpler than the complicated Value in Use process described in these paragraphs (and in BC7.39)? The justification for the Current Operational Value in BC7.26 and BC7.27 is not convincing, as it appears to be just a change in terminology (instead of

[1] According to the IASB Conceptual Framework, **Value in Use** is a measurement basis that reflects entity-specific current expectations about the amount, timing and uncertainty of future cash flows; and **Current Cost** is a measurement basis that reflects the current amount that would be paid to acquire an equivalent asset or received to take on an equivalent liability. Current Cost is the same as **Replacement Cost**.

Replacement Cost or Current Replacement Cost[2]). Furthermore, the reasoning underlying the removal of Replacement Cost (BC7.33) is also inconclusive. Perhaps the Replacement Cost Method is more straightforward and could be re-considered[3].

All this unclarity arises because ED 76 is not complete on its own. More examples and clarifications are required. Some things become clear when reading Appendix B of ED 77. Here it becomes obvious that the Cost Approach to measure Current Operational Value involves considering the Current Replacement Cost (B29 of ED 77). The income approach involves the same complications as Value in Use[4]. At the same time, the market approach is described as "rarely applicable". In other words, by taking the Cost Approach, the Current Operational Value is simply the Current Replacement Cost. Therefore, we suggest replacing the term 'Current Operational Value' with 'Current Replacement Cost', while eliminating the other two techniques.

With regards to qualitative characteristics, Par. 7.52 claims that '… *It may also provide a useful basis for comparison with other entities that report on the same basis* …'. We do **not agree** with Par. 7.52 because Current Operational Value basis is entity-specific (see par. 7.49). Par. 7.56 tries to patch this up, but perhaps it may be better to remove such inferences.

Our uncertainties regarding this measurement basis are very well reflected in the concerns expressed in the Alternative View of Mr. Todd Beardsworth (pages 29-30). We tend to support the Alternative View in ED76 regarding this measurement basis.

Furthermore, in our opinion, there is no requirement for ED 77 as a standalone standard. Its elaborations should be integrated with those of ED 76 to make Chapter 7 of the Conceptual Framework more informative and complete, as fully explained in our general comments above.

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[2] This is even more evident in Par B2 of ED 77.

[3] In IPSAS, replacement cost is a proxy measure for value in use.

[4] We do not wish to comment on the absurdity of discounting the stream of cash inflows generated by tourists in order to determine the current operational value of a naturally occurring heritage item (ED 77, Par. B38[b]).

Specific Matter for Comment 4:

It is proposed to substitute a general description of value in use (VIU) in both cash-generating and non-cash-generating contexts, for the previous broader discussion of VIU. This is because the applicability of VIU is limited to impairments. Do you agree with this proposed change? If not, why not? How would you approach VIU instead and why?

No, we do not agree with the inclusion of the section on 'Value in Use' (that is, pars. 7.57 to 7.62). As they stand, these paragraphs are confusing. The impression is given that the IPSASB is not decided on whether Value in Use is a measurement basis or not. If an asset is impaired, it shall be disclosed at Value in Use – is it a measurement basis or is it a measurement technique? The justification in BC7.41 is not convincing.

Please refer to our response to SMC 3 and note the overlap that we see between Value in Use and Current Operational Value.

'Value in Use' stands for the economic benefits resulting from fruition of certain fixed assets[5], whereas the 'Value in Exchange' represents the alienation benefits if the capital good would be sold on a market. According to IPSAS, apart from economic benefits, capital goods are assets if they deliver a service potential to the entity. One could argue that this service potential certainly represents 'Value in Use' not for the government – which does not benefit from the public services it provides - but from the point of view of the citizens who receive those services. As such, it is very difficult to measure the 'value' of those services through their 'Value in Use' to the entity.

Due to the difficulties to measure Value in Use, Replacement Cost is already considered as a proxy. In our opinion, **Value in Use should be replaced with Replacement Cost** (or Current Replacement Cost) because it is a more straightforward and practical measurement technique. This applies also for the IPSASs dealing with impairment.

[5] See for example: Barton, A. D., (2000) Accounting for public heritage facilities – assets or liabilities of the government? *Accounting, Auditing & Accountability Journal*, 13(2), pp. 219-235.

Specific Matter for Comment 5:

Noting that ED 77, *Measurement*, proposes the use of the cost approach and the market approach as measurement techniques, do you agree with the proposed deletion of the following measurement bases from the Conceptual Framework: • Market value—for assets and liabilities; and • Replacement cost—for assets? If not, which would you retain and why?

We agree with the removal of market value. See also our response to SMC 2.

With regards to Replacement Cost, see our response to SMC 3. In view of the complicated and subjective methodology underlying Value in Use and the proposed Current Operational Value, perhaps the Replacement Cost Method could be re-considered because it is simpler and more straightforward. The reasoning underlying the removal of Replacement Cost (BC7.33) is inconclusive. Furthermore, Pars 23 to 25 of ED 77 Measurement, seem to reflect an alignment of Current Operational Value with the Replacement Cost.

On the other hand, Pars 43 and 44 of ED 77 Measurement state that the Cost Approach is often referred to as Current Replacement Cost – in which case then, the Replacement Cost would be a measurement technique rather than a measurement basis.

The inappropriately called 'Cost Approach' is a measurement technique applicable to Current Operational Value and Fair Value. We describe this term as inappropriate because it can be mistaken to refer to the historical cost.

Specific Matter for Comment 6:

The IPSASB considers that the retention of certain measurement bases that were in the 2014 Conceptual Framework is unnecessary. Do you agree with the proposed deletion of the following measurement bases from the Conceptual Framework? • Net selling price—for assets • Cost of release—for liabilities • Assumption price—for liabilities If not, which would you retain and why?

We agree with the removal of these alternative bases related to **liabilities**. The Cost of Fulfillment basis should prove to be sufficient.

As for the Net Selling Price, we agree that this is not considered as a measurement basis, however, we would expect it to be mentioned as a technique in ED 77.

Specific Matter for Comment 7:

Are there any other issues relating to Chapter 7: Measurement of Asset and Liabilities in Financial Statements of the Conceptual Framework that you would like to highlight?

Re Historical cost:

Par. 7.28: The last sentence states that "*Where budgets are prepared on the historical cost basis, historical cost information demonstrates the extent to which the budget has been executed*." The purpose of this sentence is not entirely clear. Perhaps the sentence should be clarified to reflect the wording as in BC7.23. The reasoning in BC7.23 is more understandable.

Par. 7.30: We suggest extending the second sentence as follows: '*Historical cost, less any accumulated impairment loss and depreciation or amortization, can provide information on the amount of assets that may be used as effective security for borrowings, provided that the asset could be considered as available for disposal*.' It should be noted that "availability for disposal" is applicable as a consideration for all borrowing security purposes, and not only for historical cost.

Re Liability Measurement:

Another critical issue is raised by the application of current value to liability measurement. A liability represents an outstanding obligation to pay a certain amount in the future, generally to a third party. Public reporting and budgeting are concerned with securing the discharge of this obligation by controlling public spending. A liability is always a monetary item, i.e. an amount of monetary units which has to be paid at a defined and already known deadline. However, according to the ED76, even historical cost measurement is affected by current value:

Par. 7.65: *Under the historical cost model initial measures are adjusted by using a technique to reflect factors such as the accrual of interest, the accretion of a discount or amortization of a premium.*

Moreover, the ED76 does not mention the risk of having an entity recording a surplus when discounting distressed liabilities at current value due to its own mismanagement or interest rate policy measures (see Par. 7.74). The problem with pro-cyclical effects of such measurements is also ignored (reduction of interest rates involve higher fair value for liabilities, although it reduces the cost of funding).

The fundamental misunderstanding is that the entity does not hold the liability, but it owes it.

Date: 21st October, 2021 Signed on behalf of the persons listed below:

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