MONASH University
Business and Economics
Department of Accounting and Finance

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Director, Accounting Standards
Canadian Accounting Standards Board
227 Wellington Street
Toronto, Ontario M5C 3H2
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Submission on Discussion Paper

Measurement Bases for Financial Accounting: Measurement on Initial Recognition

A copy of my submission on the Discussion Paper is attached. The discussion paper provides a good starting point for improvement in the measurement of the elements of financial statements, in particular providing a rationale for the removal of many of the inconsistent practices that are currently required or allowed by financial reporting standards. The Board and its technical staff must be commended for its contribution to the resolution of the measurement debate.

If technical staff of the Board wish to discussion any matter raised in the submission I can be contacted either by email:

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or (after 23 May 2006) by telephone on + 61 3 9905 2701.

Yours truly,

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Lecturer in Accounting

Attachment: Submission on Discussion Paper

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Submission by Ian Langfield-Smith (Monash Univerity) on Discussion Paper
Measurement Bases for Financial Accounting – Measurement on Initial Recognition

Q1. Do you agree that the list of identified possible measurement bases (see paragraphs 33-51 of the condensed version and paragraphs 69-74 of the main discussion paper) sets out the bases that should be considered? If not, please indicate and explain any changes that you would make.

I agree that each of the listed possible measurement bases should be considered. The absence of an explicitly exit-value based measurement base could be criticised. However, since fair value can embrace both exit and entry measures, this may be sufficient. Off course, the exit-v-entry measure issue is not as critical on initial recognition as it is for post recognition remeasrement (which is outside the scope of the discussion paper).

It would also have been useful to examine a measure that is purely market-based, for example, one limited to fair values determined in an active, liquid market.

Q2. Do you agree with the working terms and definitions, and supporting interpretations, of each of the identified measurement bases (see paragraphs 33-51 of the condensed version and paragraphs 77-96 of the main discussion paper)? If not, please explain what changes you would make. In particular, do you have any comments on the term "fair value" and its definition (in light of the discussion in paragraphs 46-48 of the condensed version and paragraphs 88-93 of the main discussion paper)?

In general, the terms and definitions, and supporting interpretations are in general suitable. However, I am share the view attributed to the FASB that fair value should be defined as an exit measure, rather than being capable of both being an exit measure and entry measure.

Q3. It is proposed that there are two fundamental sources of differences between the identified bases for measuring assets and liabilities on initial recognition:

(a) market versus entity-specific measurement objectives, and
(b) differences in defining the value-affecting properties of assets and liabilities.

(See paragraph 52 of the condensed version and paragraph 97 of the main discussion paper.) This proposal and its conceptual implications are the subject of chapters 4 and 5. Do you agree that these are the fundamental sources of differences between asset and liability measurement bases on initial recognition? If not, please indicate the fundamental sources of differences you have identified, and provide the basic reasons for your views. For any different fundamental sources you have identified, please indicate how these might be examined and tested.

In the context of the issues being address, the specification of the issue is appropriate.

Q4. The paper analyzes the market value measurement objective and the essential properties of market value.

(a) Do you believe that the paper has reasonably defined the market value objective and the essential properties of market value for financial statement measurement purposes (see paragraphs 54-56 and 105-112 of the condensed version and paragraphs 99-110 and 236-241 of the main discussion paper)? If not, please explain why not, and what changes you would propose, or different or additional considerations that you think need to be addressed.

I am in general agreement with the approach taken.

(b) Do you agree with the proposed definition of "market" (see paragraphs 55-56 of the condensed version and paragraphs 107-110 of the main discussion paper)? If not, please explain why you disagree, and indicate any changes you would make and any issues that you believe should be given additional consideration.

The proposed definition appears to be sufficiently comprehensive for the purposes of financial reporting.

(c) Do you agree with the fair value measurement objective as proposed, and its derivation from the market value measurement objective (see paragraph 102 of the condensed version and paragraphs 111, 228 and 229 of the main discussion paper)?

I have reservations about describing a measure that is not found in an active liquid market as a fair value. However, it is possible that my corners can be dealt with through appropriate financial report disclosures. In terms of the objective of making the measurement, the extension of the fair value concept as suggested in the paper is likely to enhance, rather than detract from achievement of that objective, ***provided*** appropriate disclosure is made.

Q5. Do you agree with the definition and discussion of entity-specific measurement objectives (see paragraph 57 of the condensed version and paragraphs 112-116 of the main discussion paper) and their relationship to management intentions (see paragraph 58 of the condensed version and paragraphs 117-121 of the main discussion paper)? If not, please explain why you disagree.

For the purposes of a preliminary evaluation of the issues, the definition and discussion are both reasonable and appropriate. The presentation of the issues is even-handed and well presented.

Q6. Do you agree with the comparison of market and entity-specific measurement objectives (see paragraph 59 of the condensed version and paragraph 122 of the main discussion paper) and with the proposed conclusion that the market value measurement objective has important qualities that make it more relevant than entity-specific measurement objectives for assets and liabilities on initial recognition (see paragraphs 60-61 of the condensed version and paragraphs 123-129 of the main discussion paper)? If not, please explain your views.

While one could quibble about terminology adopted and suggest that other factors should have been addressed, the presentation is sufficiently comprehensive to support the conclusion that market value measurement objective is more relevant to users of financial reports than the entity-specific measurement objective in the context of initial recognition.

Q7. (a) It is reasoned that there can be only one market (fair) value for an asset or liability on a measurement date (see paragraph 62 of the condensed version and paragraphs 131-138 of the main discussion paper). Do you agree with this conclusion? If not, please explain why you disagree.

As a general proposition, it is reasonable to conclude that there can only be on market (fair) value measure on a measurement date.

(b) It is proposed that differences between apparent market values for seemingly identical assets or liabilities on initial recognition may be attributable to:

(i) differences between the value-affecting properties of assets or liabilities traded in different markets, or
(ii) entity-specific charges or credits.

(See paragraph 63 of the condensed version and paragraphs 131-138 of the main discussion paper). However, the paper notes the existence of multiple markets for some assets and liabilities, and the possibility that they may be due to market access restrictions that require further investigation (see paragraphs 74-82 of the condensed version and paragraphs 95-109 of the main discussion paper).
Do you agree with these proposals, within the caveats and discussion presented? If not, please explain why you disagree.

Subject to the caveat about multiple markets, I agree with the proposal. The existence of market imperfections, particularly those that limit on the ability of participants to act in particular markets as a buyer, a seller, or both, needs further investigation. I am not convinced that further empirical investigation will help resolve the issues although it may clarify the extent of the potential problem. It is my belief that the market value objective can be used to determine from which market the measure of fair value is to be made. It is unnecessary at this stage to determine if the relevant market is the exit market or the entry market to which the entity has access, although my inclination – subject to further argument – would be to favour the fair value

measured in an exit market. In such a case, there would indeed be only one fair value.

Q8. Do you agree that a promise to pay has the same fair value on initial recognition whether it is an asset or a liability, and that the credit risk associated with a promise to pay enters into the determination of that fair value with the same effect whether it is an asset or liability (see paragraph 65 of the condensed version and paragraphs 142-147 of the main discussion paper)? If you do not agree, please explain the basis for your disagreement.

In the context of initial recognition, a promise to pay has the same fair value whether it is an asset or a liability. As a matter of logic, one would expect contracting parties to include credit risk in pricing the promise to pay, and thus it will be included in the fair value of the promise. Since the fair value of the promise to pay can differ from the face amount of the promise to pay, in order for the financial statements to allow a proper assessment of solvency and liquidity, it would be necessary to disclose both the face amount and discharge date of the promise to pay.

A caveat is necessary. While this analysis is valid for the measure of a liability on initial recognition, there are significant problems with the application of fair value to liabilities post recognition. The use of fair value is problematic due to the possibility of significant restrictions on the ability of the entity to participate in the relevant market to discharge the obligation at fair value. If the liability cannot actually be discharged at its fair value, then the fair value measure is either miss-specified (because it lacks representational faithfulness) or there is a need for appropriate note disclosure explaining the nature and significance of an inability to discharge the obligation at the recognised amount. While this issue is beyond the scope of the issues being addressed, it may result in a need for remeasurement at the next reporting date.

Q9. The paper makes the following proposals with respect to defining the unit of account of the asset or liability to be measured on initial recognition:

(a) The appropriate individual item or portfolio unit of account on initial recognition is generally the unit of account in which the reporting entity has acquired the asset or incurred the liability (see paragraphs 67-70 of the condensed version and paragraphs 149-154 of the main discussion paper).

(b) The appropriate level of aggregation for non-contractual assets on initial recognition is the lowest level of aggregation at which an identifiable asset is ready to contribute to the generation of future cash flows through its sale or use (see paragraphs 71-73 of the condensed version and paragraphs 157-161 of the main discussion paper).

Do you agree with these proposals within the caveats and discussion presented? If not, please explain why, and in what respects, you disagree.

I agree with the proposals within the caveats and discussion presented.

Q10. It is suggested that, in many cases, the best market source on initial recognition is the market in which the asset or liability being measured was acquired or issued. However, some significant situations are noted in which a different source may be appropriate, and research is proposed into possible multiple markets (see paragraphs 75-82 of the condensed version and paragraphs 162-182 of the main discussion paper). Do you agree that the paper provides a reasonable analysis of market sources and their implications on initial recognition? If not, please provide reasons for disagreeing, and indicate any additional analysis or research you would think should be carried out.

Yes, it is agreed that the approach taken is an appropriate one.

Q11. The paper concludes that transaction costs, as defined, are not part of the fair value of an asset or liability on initial recognition (see paragraphs 86-87 of the condensed version and paragraphs 193-200 of the main discussion paper). Do you agree with the proposed definition of transaction costs? Do you agree with the above conclusion? If you disagree, please explain your reasons and what you believe the implications of your different view would be for fair value measurement of assets and liabilities on initial recognition.

It is agreed that transaction costs are not part of the fair value of an asset or liability on initial recognition. For the present, I am content with the proposed definition. This is on the understanding that the following would be a transaction cost: that a borrower issues debt securities at a discount to face amount to an underwriter/lead-lender who takes the discount instead of a direct payment of a fee for the services provided. This is clearly a transaction cost, and if the definition does not include such amount … which I think it does … it requires further attention.

Q12. Do you agree with the proposal that, when more than one measurement basis achieves an acceptable level of reliability, the most relevant of these bases should be selected (see paragraph 89 of the condensed version and paragraph 202 of the main discussion paper)? If not, please explain why you disagree, and indicate how you would settle trade-offs between the relevance and reliability of alternative measurement bases.

Yes, agreed.

Q13. Do you agree with the two proposed sources of limitations on measurement reliability — estimation uncertainty and economic indeterminacy — and supporting discussion (see paragraphs 90-100 of the condensed version and paragraphs 204-216 of the main discussion paper)? If not, please explain your view.

Yes, agreed.

Q14. Do you agree that fair value is the most relevant measure of assets and liabilities on initial recognition of assets and liabilities, and therefore should be used when it can be estimated with acceptable reliability (see analyses of fair value and alternative bases in chapter 7, and discussion of measurement date on initial recognition in paragraphs 179-180 of the condensed version and paragraphs 410-415 of the main discussion paper)? If not, please explain why.

Yes, agreed.

Q15. Do you agree that fair value is not capable of reliable estimation in some common situations on initial recognition (see paragraph 104 of the condensed version and paragraphs 232-277 of the main discussion paper)?

Agreed.

More specifically, do you agree that:

(a) A single transaction exchange price should not be accepted to be equal to fair value unless there is persuasive evidence that it is (see paragraphs 106-114 of the condensed version and paragraphs 243-252 of the main discussion paper), and

Agreed.

(b) A measurement model or technique cannot be considered to achieve a reliable estimation of the fair value of an asset or liability when the estimate depends significantly on entity-specific expectations that cannot be demonstrated to be consistent with market expectations (see paragraphs 115-118 of the condensed version and paragraphs 263-268 of the main discussion paper)?

Agreed.

Please provide explanations for your views on these questions if they differ significantly from the conclusions and supporting arguments presented in the paper.

But for the requirement to identify amounts determined by estimators of fair value and to make appropriate disclosures to allow an informed assessment of the reliability and representational faithfulness of the estimator, I would not support the use of anything other than level 1 and level 2 measures.

Q16. Do you agree with the paper's analyses and conclusions with respect to the comparative relevance and reliability of:

- **historical cost (see paragraphs 120-137 of the condensed version and paragraphs 281-319 of the main discussion paper);**

Yes, I agree.

- **current cost - reproduction cost and replacement cost (see paragraphs 138-154 of the condensed version and paragraphs 320-361 of the main discussion paper);**

  Yes, I agree.

- **net realizable value (see paragraphs 155-161 of the condensed version and paragraphs 362-375 of the main discussion paper);**

  I am not convinced by the arguments presented against the relevance of net realisable values. However, while I do not find the reasoning convincing, sufficient doubt about the relevance of the measure and in particular the potential impact of entity specific measures, to suggest that considerably more research is needed to refine the understanding of net realisable value. There is also a nagging doubt that the models developed by Stirling and Chambers have been represented as ones dealing with net realisable value in a way in which neither Stirling nor Chambers would agree; unfortunately time constraints preclude my revisiting their works to resolve this doubt. However, the problem of entity specific disposal costs and the possibility of disposal in a condition other than current condition, give rise to questions about representational faithfulness of the measures.

- **value in use (see paragraphs 162-169 of the condensed version and paragraphs 376-392 of the main discussion paper); and**

  It is agreed that value in use as such is neither relevant nor reliable. However, the underlying present value techniques may allow the technique to be used to estimate fair value, provided stringent conditions are imposed to ensure representational faithfulness of the measure.

- **deprival value (see paragraphs 170-178 of the condensed version and paragraphs 393-409 of the main discussion paper)?**

  I am in general agreement with the analysis. The complexity of deprival value suggests that it may be a measure that users will have difficulty is assessing and consequently users are likely to misunderstand the implications that can be drawn from such a measure.

Please provide reasons for any disagreements, and any advice you may have as to additional analysis or research that you believe should be carried out.

See also my comments on question 17.

Q17. The paper discusses substitutes for fair value when the fair value of an asset or liability cannot be reliably estimated on initial recognition. Do you agree that, when other measurement bases are used as substitutes for fair value on initial recognition, they should be applied on bases as consistent as possible with the fair value measurement

objective (see paragraph 186 of the condensed version and paragraph 417 of the main discussion paper)? If not, please explain why.

If substitute measures for fair value are permitted, they must be applied in a manner consistent with the fair value measurement objective. Absent such consistency, the resultant amounts would lack the necessary qualitative characteristics for meaningful addition; they would not be as a matter of logic additive and would result in aggregate amounts lacking representational faithfulness.

Q18. Do you agree with the proposed hierarchy for the measurement of assets and liabilities on initial recognition (see chapter 8)? If not, please explain your reasons for disagreeing and what alternatives you might propose.

It is proper that a hierarchy for measurement be developed if measures other than direct measures of fair value are to be permitted. While I am comfortable with the measures at levels 1 and 2, and am not convinced that the measures in level 3 have a sufficient nexus with fair value and the objective to which the fair value measure is directed. This means that there is doubt about the additively of the measures. However, given the proposed identification and additional disclosures for these measures, it may produce a reasonable interim basis for improvement in financial reporting.

Q19. Do you have comments on any other issues or proposals, including the proposals for further research (see paragraph 189 of the condensed version and paragraph 441 of the main discussion paper)? If so, please provide them.

I have no comments in addition to those made in response to prior questions.