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Dear Sir or Madam:

Discussion Paper *Measurement Bases for Financial Accounting – Measurement on Initial Recognition*

We are grateful for the opportunity to comment on this Discussion Paper. We have various general comments before answering the specific questions raised in the Paper.

General comments

We welcome the review of the conceptual concepts surrounding the measurement of assets and liabilities on their initial recognition. However, a significant weakness of the Paper is that it treats this topic in almost complete isolation from other, equally important, conceptual issues. The Paper's proposals have significant implications for the timing of recognition, for determining which amounts may or may not be recognised, as well as post-recognition questions, in particular, performance measurement. Experience has shown that the greater use of fair valuation techniques in the preparation of financial statements has resulted in significantly higher earnings volatility, and so we view the contemplation of such far-reaching proposals without considering their impacts as unhelpful.

Our main reservation with the Paper arises from the lack of consideration paid by it to the information needs of users of financial statements. The Paper assumes that users would find financial statements more relevant and/or reliable if fair valuation methods were applied to the recognition of assets and liabilities that are currently not recognised at fair value, for example, property, plant and equipment, but it provides no evidence for this view.

Again, we feel strongly that changes in these fundamental concepts cannot be contemplated without first ascertaining users' information needs and preferences.

The most significant proposal made by the Paper is that all assets and liabilities should be recognised initially at fair value, based either on prices determinable from reference markets for identical or similar assets and liabilities or, if such prices are not available, by applying valuation models using market inputs. If fair value cannot be determined, the Paper proposes the application of other valuation models, based on entity-specific inputs, including historical cost.

By the authors' own admission, the task of ascertaining an entirely objective, market-specific price for an asset or liability is beset with numerous "real-world" difficulties, not least because most assets and liabilities are not traded with any degree of regularity. In reality, value measurements are made by an entity's management based on its assessment of knowledge available to it and on its judgements of relevant business factors, including associated risks. Invariably, a range of possible outcomes results from such valuation exercises. In a financial reporting context, management is then tasked with narrowing down the outcomes to a single figure. Others may view the same information differently. (The same applies to market prices, which explains in part why they change.) Moreover, the decision to invest in an entity is the responsibility of the investor. Reporting the fair value of the net assets (and hence equity) of a company, for which a transparent market does not exist, inappropriately shifts a large degree of risk and responsibility associated with the investment decision from the investor to management.

We agree with the Paper's authors that more work is required before the conceptual issues raised can be resolved, and hope the IASB will find the suggestions made in this letter useful. In particular, we would welcome a thorough review of, and debate on, the fundamental conceptual issues of recognition and measurement taken together, rather than in isolation.

Specific questions

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.*

We agree that the list of identified measurement bases sets out those bases that merit consideration. We further agree that it is appropriate to omit present value from the list because it is a measurement method rather than a measurement basis and would support revision of the *Framework* to that effect.

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)?*

We do not support the interpretations of the definitions of historical costs presented in paragraphs 35 –36 of the condensed version and 78 – 79 of the main discussion paper. We believe that the assumptions employed in these interpretations are biased toward a fair value view. The concept of realization in the historical cost approach is significantly diluted in this interpretive view.

Additionally, we would appreciate greater clarification on the following points:

- While the topic of recognition timing is outside the scope of this Paper, we note that the definition of *historical cost* touches on this important issue when it refers to historical cost being measured at the time of acquisition. Without addressing what is to be taken as the time of acquisition it would be premature, in our view, to conclude on our agreement, or otherwise, with the proposed definition of *historical cost*.

- The definition of *value in use* refers to an asset's "useful life", but does not explain how this term should be understood. We consider this to be important, given the discussions elsewhere in the Paper of market-specific and entity-specific measurement bases. Generally, entity management determines useful lives, and that is how we have understood the term as applied in the Paper.

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.

We understand from the Paper's discussions in chapters 4 and 5 that these objectives and properties are concerned more with valuation bases than with measurement bases. Consequently, certain objectives and properties of the historical cost measurement basis are ignored, in particular, which costs (such as financing, overheads and pre-recognition costs) should or should not be included. The result is, in our view, a lack of balance in the Paper's comparison of historical cost as a measurement basis with alternative bases.

Q4. The paper analyses 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.

(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.

(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)?

The Paper's definition of the market value measurement objective forms a fair, albeit hypothetical, starting point for the discussion of measurement bases that attempt to incorporate fair valuation techniques.

We note that the term "market" is widely understood to refer to all types of market. However, the definition of the term "market" proposed in the Paper is actually a description of only one particular type of market, i.e. one which demonstrates "semi-strong efficiency" (as described by Fama). We are of the view that this attempted addition to the business lexicon is both redundant and misleading, and would suggest using instead a modified term, if necessary, such as "active, well-informed liquid market".

The hypothetical nature of this definition does not support the conclusion set forth in paragraph 102 of the condensed version and the corresponding paragraphs in the main version. Only when an actual transparent market exists with the above characteristics can you achieve the superior measurement state described in these paragraphs. However, such markets do not exist for the majority (although not all) of assets and liabilities recognized on most companies' balance sheets. In these cases, we do not agree with the presumption that sufficient valuation techniques exist to provide adequate predictive value of ultimate realization in the context of investors relying upon financial data.

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.*

Except for the qualifications noted in our response to question 3, we agree with the definition and discussion of entity-specific measurement objectives set out in the Paper, as well as their relationships with management intentions. However, we believe that the qualifications are fundamental to the discussion at hand.

However, the discussion raises interesting points about the assumptions made in previous paragraphs of the Paper concerning market-specific measurement objectives. Given that a market participant will approach that market with a set of what can only be described as entity-specific objectives, the result is that a market value derived at a point in time will be based on most recent transactions, which would not necessarily represent a "consensus" of all market participants. Historical analysis has also shown that in any case, such consensuses are far from infallible. The consequences of such limitations are noted in our response to the following question.

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.*

The comparison of market-specific and entity-specific measurement objectives (in paragraph 122) omits a number of what we feel to be important implications:

- Please refer to our response to question 4 as to the impact of the hypothetical nature of the market assumptions.
- The treatment of any gains or losses arising on initial recognition because of differences between market-specific and entity-specific measurements is not addressed at all.
- The comparison assumes that, in applying market-specific or entity-specific measurement bases, one approach can be applied with equal validity to all types of assets and liabilities. It is generally accepted, for example, that assets and liabilities held for trading, including contractual assets and liabilities, provide useful information if they are measured at fair value (as currently defined). But

assets and liabilities "held for own use", such as property, plant and equipment used in an entity's business processes, are usually carried at historical cost (as modified by impairments and depreciation) even though there is an option under IAS 16 to revalue such assets. The Paper does not appear to envisage the possibility that users of financial statements (as well as their preparers) might consider this acceptable, if not preferable, to the wholesale fair valuation of all assets and liabilities.

- Currently, certain intangible assets (most notably, brands) are not recognised if generated internally, but are recognised if acquired, either separately or in the context of a business combination. The main justification for this has been that such assets cannot be measured reliably, or – to use terminology from the Paper – they cannot be measured using market-specific measurement bases. The Paper would therefore appear to imply that, if such assets can be measured using market-specific valuation models, they should, conceptually, be recognised. However, the Paper does not address this implication.

We appreciate the need to address the issue of measurement on initial recognition in conceptual terms but feel that, without further analysis (for example, by application to specific circumstances), the issues raised cannot adequately be concluded upon, or indeed fully understood.

Furthermore, the Paper's conclusion that market-specific measurement objectives are superior to entity-specific objectives is, in our view, unsupported. In particular, for the reasons stated above, we do not accept the argument that market-specific measurement bases are more readily understood than entity-specific measurement bases.

Finally, we raise the general point that financial reporting does not occur in "real time". The fact that it is possible to obtain immediate market values for securities and commodities that are traded on exchanges does not, in our view transfer the same level of relevance to financial reporting, the preparation of which takes several weeks or months. Given the necessary time lag in preparing financial statements, it could be argued that historical cost-type (i.e. entity-specific) measures are as relevant and certainly more reliable than market values, which if reliably determinable at the reporting date, may well have changed significantly since.

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.*

(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 [162-182] of the main discussion paper).

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

We disagree with the assertion that the Paper reasons there can only be one market value for an asset or liability: our reading of the Paper is that its authors have found there to be significant, valid and, in some cases, unquantifiable differences in market prices. The assertion that there can only ever be one market price is therefore an entirely theoretical hypothesis that cannot be reconciled with reality. As such values are projections of estimated realizations into cash, they typically are formulated in ranges in the absence of a transparent liquid market.

Viewed in this light, it appears to us unreasonable to accept that a market value (or, more likely, values) should be considered by users of financial information as more relevant or more reliable than other measurement bases.

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.

Our view is that the incorporation of credit ratings into the valuation of a financial instrument will be subject to the same limitations as other market-specific measurements. For example, the Paper assumes that a given debtor will be awarded the same rating by all rating agencies, and therefore does not address issues of "rating inefficiencies".

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.

We are in agreement with the proposals.

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.

The Paper demonstrates in a number of places that there are both known and unknown causes for differences in market prices. Therefore, the conclusion of the Paper that, nevertheless, an asset or liability should have only one fair value appears to us contradictory. If the Paper's authors believe that such differences can be identified and quantified for financial reporting purposes (and that such efforts will result in benefits to users of financial statements), then we agree that further analysis is merited.

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.

We do not agree with the proposed re-definition of transaction costs as we believe users will take the term, as re-defined, to include all transaction costs. For the sake of clarity, we would prefer irrecoverable transaction costs to be referred to as such.

We have reservations about the proposal to exclude irrecoverable transaction costs from the fair valuation of assets and liabilities without further analysis of whether such costs are priced in by the market.

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.

The Paper notes the need to sometimes trade off information "reliability" against information "relevance", and appears to assume that users, if given a choice, will always sacrifice reliability in favour of relevance. However, the Paper does not provide evidence to support this.

Nor does the Paper define what it means by an "acceptable level of reliability". In the context of the question, are we faced with a choice between two or more equally reliable measurement bases? If this is so, then obviously the most relevant basis should be selected, assuming it can be agreed which basis is the most relevant (refer to the next question). If, as is the case in practice, we are faced with a choice of measurement bases that are reliable to different extents, then the trade-off between reliability and relevance is a much more complex question, the answer to which must, in our view, take other issues into account: other recognition criteria; post-recognition issues, including performance measurement; presentation and disclosure matters.

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.

We agree with the distinctions made, however, we do not agree that estimates subject to "economic indeterminacy" are more immune to measurement bias than those subject to "estimation uncertainty". Paragraph 205 refers to uncertainties concerning estimates of future cash flows to be received from a loan receivable but appears to ignore the fact that those estimates are as susceptible to measurement bias as estimates requiring allocations.

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.

For the reasons explained elsewhere in our responses, we do not agree that the Paper offers an acceptably convincing argument that fair value is always the most relevant measure of assets and liabilities on their initial recognition.

In summary:

- The Paper excludes from its scope other equally important conceptual questions, such as other recognition criteria and post-recognition concepts. In our view, it would be an error to attempt to conclude on the main proposal in this Paper without also considering the implications for other conceptual issues (please also refer to our responses to questions 6 and 16).
- The Paper concludes that users would find financial information based on fair, or market, values more relevant, and at the same time appears to assume that users have a general preference for adopting such an approach, but it does not offer evidence to support this view. In our view, gaining a detailed understanding of what users' needs should precede any contemplation of such fundamental changes to the conceptual framework of financial reporting and preferences are (please also refer to our responses to question 12).
- The Paper assumes that the application of mixed measurement models is undesirable and attempts to conclude that it is unnecessary. We are, however, unconvinced by the argument that in the complex business world, a "one size fits all" approach is necessarily desirable. The Paper's lack of balance in assessing competing measurement models does not help the authors' case (please also refer to our responses to question 6).
- In our view, the Paper's own conclusions on the limitations of markets and market values undermines its main case for applying market valuation models in financial reporting (please also refer to our responses to questions 6, 7, 8, 10 and 15).

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)? 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

(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)?

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

We consider that, in most common situations, fair value as defined (i.e. market value) is not capable of reliable estimation, primarily because most assets and liabilities are not actively traded and entity-specific valuations are combined with negotiations between buyer and seller.

In response to the specific question of whether or not a single transaction price should be accepted to be equal to fair value, our view is that the transaction price should be taken to be a reasonable approximation of fair value unless there is evidence that this is not the case. In other words, we concur with the view set out in CON 7, paragraph 27 (as cited in paragraph 245).

We concur with the assertion that entity-specific valuations cannot usually be considered to be equal to fair value if fair value is to be based on observable market prices.

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

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

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

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

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

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

(f) 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.

Historical cost

In our view, the Paper presents a somewhat one-sided case for the preference of fair/market value over historical cost. It does not address the importance, or otherwise, of the stewardship role of financial reporting, and assumes users have a greater preference for and will more easily understand measurements based on fair/market values than measurements based on historical cost.

We are also unconvinced by the proposal that irrecoverable transaction costs should be included from the measurement of an asset or liability based on historical cost. In practice, such costs (for example, irrecoverable VAT on motor cars) are priced into an investment decision and can therefore be considered to be recoverable from the holding of that asset or liability.

Current cost

We find the argument in the Paper that current cost measurement is more relevant than historical cost simply because it may be a closer approximation (in a few cases) to fair value to be over-simplistic.

This is not to say that current cost measurement bases do not have merit. It is common practice among integrated oil industry entities to provide disclosures of cost of sales and earnings on a current cost basis because this information is widely considered more useful to users than historical cost alone.

Value in use

As noted elsewhere in our responses to this Paper, we consider that an analysis of whether the useful life of an asset should be market- or entity-specific should be made before the usefulness of this measurement basis can properly be concluded upon.

Deprival value

We are concerned by the lack of consideration paid to the implications of applying this measurement basis. For example, are assets that cannot be measured at market value to be subjected to impairment tests on initial recognition, as is implied here?

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.

Where an asset or liability is to be measured at fair/market value on initial recognition, it appears appropriate to apply other measurement bases that are consistent, if possible, with the fair value measurement objective.

However, as also stated elsewhere in our responses, we remain unconvinced that all assets and liabilities need to be recognised initially at fair value in order to provide users with useful information. Consequently, the hierarchy would not, in our view, be appropriate in measuring the amounts initially recognised in all instances.

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.

We agree that where an asset or liability is required to be recognised initially at fair value (for example, financial instruments), the hierarchy provides useful guidance, notwithstanding the reservations set out elsewhere in our responses.

However, as also stated elsewhere in our responses, we remain unconvinced that all assets and liabilities need to be recognised initially at fair value in order to provide users with useful information. Consequently, the hierarchy would not, in our view, be appropriate in measuring the amounts initially recognised in all instances.

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.

As stated elsewhere in our responses, we believe a number of important areas require consideration before this phase of the review of the conceptual framework can be completed:

- An assessment of the practicalities of developing fair market valuations constantly in situations where transparent markets do not exist.
- other conceptual issues, such as (other) recognition criteria, post-recognition issues, presentation and disclosure;

- a detailed assessment of the impacts of these proposals on particular types of assets and liabilities, including government grants and internally-generated intangible assets; and
- the treatment of excluded costs, such as pre-recognition costs.

Yours sincerely,

Bob Deere

Vice President Accounting and Reporting