INSTITUT
DER
WIRTSCHAFTSPRÜFER
IDW

Sir David Tweedie
Chairman of the
International Accounting Standards Board
30 Cannon Street

London EC4M 6XH
United Kingdom

Düsseldorf, 22 May 2006
542/552

Dear Sir David

Re.: Discussion Paper – Measurement Bases for Financial Accounting – Measurement on Initial Recognition

We appreciate the opportunity to comment on the above mentioned discussion paper issued by the IASB in November 2005 and would like to submit our comments as follows:

The references given refer to the condensed version of the discussion paper, unless stated otherwise.

General Remarks

We do not agree with the focus the IASB has chosen for this discussion paper and we strongly reject the proposed fair value measurement approach. In our opinion, the issue of adequate measurement concepts for initial recognition should not be discussed without considering issues relating to re-measurement as there are significant interdependencies. For financial statements conveying information useful for users, it is essential to have a consistent concept for initial and subsequent measurement as well as for capital maintenance and performance reporting. This will necessitate further research, sufficient to enable the development of an overall measurement framework, addressing the problems resulting from the use of the concept of fair value for the measurement of all assets and liabilities for initial recognition as well as re-measurement.

Institut der Wirtschaftsprüfer
in Deutschland e.V.
Tersteegenstr. 14
40474 Düsseldorf
Postfach 320580
40420 Düsseldorf

Telefonzentrale 0211/4561-0
Fax Geschäftsleitung 0211/4541097
Fax Fachabteilung 0211/4561-233
Fax Bibliothek 0211/4561-204
Internet www.idw.de
E-Mail info@idw.de

Geschäftsführender Vorstand:
Prof. Dr. Klaus-Peter Naumann,
WP StB, Sprecher des Vorstands
Dr. Gerhard Gross
Dr. Wolfgang Schaum, WP StB

Bankverbindung:
Deutsche Bank AG
Düsseldorf
BLZ 300 700 10
Kto.-Nr. 7 480 213

In addition to the overall rejection of the discussion paper, we would like to address some criticism in detail:

The major objection we would like to emphasise pertains to the fundamental assumption underlying the discussion paper, albeit not explicitly stated: the discussion paper is based on a presumption that perfect and complete markets (or at least very active and liquid markets with low transaction costs) exist for all assets and all liabilities, which is not the case in reality. The existence of market imperfections is an inevitable precondition for the existence of lucrative investments: entities are continuously searching for innovations and competitive advantages in order to remain profitable. Furthermore, in the case of perfect and complete markets, there would be no need for financial statements anyway because there would be no information asymmetry, and the discussion pertaining to the most suitable measurement concept would be dispensable. Because perfect and complete markets are an essential prerequisite for the purported information value of fair value, the discussion paper plays down the implications on both relevance and reliability of fair value. As a consequence, in our opinion, the conclusions drawn are not valid.

A further point we have observed is that the discussion paper confuses, to a large extent, the objectives and the instruments necessary or suitable to reach those objectives; for example, market versus entity-specific measurement are not two distinct objectives of financial statements. As set out in the Framework of the Board, the objectives of accounting are “decision usefulness” as well as “stewardship” or “accountability of management”. The use of measurement concepts and accounting policies is not an end in itself but a means to fulfil the objectives of financial statements. In confusing objectives with instruments the discussion paper is misleading in some respects, because it allows the authors to protect their desired conclusion – the superiority of market value measurement – against criticism by simply declaring it being an objective, which it is definitely not.

Alternative proposal for a decision-useful measurement concept

In our opinion, from a conceptual point of view, the most appropriate measurement concept for all assets, for both initial recognition and re-measurement, would be their value in use, provided it represents faithfully what it purports to represent and is free from material error and bias. Value in use would provide the most suitable information for users in making their decisions, because it would approximate the entity-specific measure of the present value of future cash flows. Value in use encompasses management’s expectations as to the future cash flows the entity can generate through the use of the asset, realising thereby its competitive advantages. On initial recognition, historical cost is the best available approximation of this value in use, because it has been evidenced by a transaction and therefore is both reliable and verifiable.

For re-measurement, it is necessary to distinguish between financial instruments and non-financial assets and liabilities:

- For financial instruments, fair value is usually identical with value in use because there are no synergies with the operational business of the entity. However, for those financial instruments for which there is no active market, fair value measures involve uncertainty concerning the underlying estimates, thus impairing both relevance and reliability of fair values based on such estimates. Therefore we would like to suggest the Board consider using (amortized) cost instead as a sufficiently relevant and reliable measurement concept in these cases.
- For all non-financial assets and liabilities that are not intended for immediate sale, fair value does not seem to be a relevant measurement concept, because it does not convey information about the intended entity-specific use. For example, it is doubtful whether fair value for operating assets in production processes is relevant, and as such this should be discussed in the context of the above-mentioned proposed new project. From a theoretical point of view, for those items it would be necessary to estimate the value in use. But as for the determination of fair value, there is inherent uncertainty in this approach. This limits reliability of value in use. In order to avoid the weaknesses concerning reliability, we suggest that value in use should be substituted by (amortized) cost for re-measurement.

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 understand that for the sake of completeness all the listed measurement concepts have been covered. But we doubt whether discussing measurement concepts that seem obviously not suitable for initial recognition actually contributes to an in depth analysis of the applicability of fair value as a general measurement concept on initial recognition. In particular, we would like to challenge whether it is appropriate to discuss deprival value in this context, being a composite of other measurement concepts. In any case, we will focus on a comparison of the strengths and weaknesses of historical cost, value in use and fair value in the following responses.

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 respect of the definition of historical cost, we would like to suggest avoiding the use of the term *fair value*, because it is already within the definition of another measurement concept. Moreover, the notion "at the time of their acquisition" might be susceptible to misunderstanding in relation to constructed assets in that historical cost could be interpreted as the fair value of the consideration given at the time the asset becomes operational, instead of the accumulated cost incurred in constructing the asset. We would therefore like to suggest the Board clarify the definition of historical cost to avoid such misunderstanding.

Concerning the definition of value in use, there is a need to clarify, that the management's expectations should form the basis for determining value in use.

In respect of the definition of fair value as proposed in the discussion paper, we would like to suggest the Board clarify one fundamental aspect of the definition, because it is currently silent as to whether it is supposed to be an entry or an exit value. Some of the conclusions of the discussion paper seem to presuppose fair value being an entry value (see for example paragraph 75), others seem to imply that it is an exit value (see for example paragraph 86). Such clarification of the definition of fair value is particularly recommendable as the assumption that there is only one market price is not applicable, as explained in more detail in our answer to question 7. Therefore, we would like to encourage the Board to consider defining fair value in a manner that takes into account the market conditions that exist in reality.

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 dif-

ferences 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 agree that differences in defining the value-affecting properties of assets and liabilities contribute significantly to the differences between asset and liability measurement concepts on initial recognition. In addition, defining the unit of account of assets or liabilities is a vital pre-condition for determining their value-affecting properties. In our opinion, the guidance given in the discussion paper on this subject would benefit from further elaboration.

Furthermore, we would like to draw attention to the fact that differences between the measurement concepts discussed also result from the different attributes underlying the use of the measurement concepts. We regard this as a fundamental source of differences. As already mentioned in our general remarks, market versus entity-specific measurement are not objectives of financial statements.

In accounting theory there are different approaches to reaching the overriding objective of decision usefulness for financial statements, as set out in the Board‘s Framework. It is not possible to depict the value of the entity as a whole solely through accounting because of the accounting principle of individual valuation. This prevents the inclusion of all synergies, because internally generated goodwill is not recognised under current accounting standards. Some measurement concepts are more suitable for representing a true and fair view of the assets and liabilities of an entity (asset-liability-approach) whereas others are more capable of enabling the users of financial statements to extrapolate possible future earnings (revenue-expense-approach) and to serve as a basis for an evaluation of the entity’s ability to generate cash or cash equivalents and the timing of, and uncertainty relating to, their generation (Framework.15). It is necessary to reach a clear decision as to which of these concepts should underlie the financial statements. Otherwise, it is very difficult to draw conclusions from the earnings figure. The revenue-expense-approach is more suitable for the purpose of drawing conclusions on the future performance of an entity. Thus, the determination of earnings based on this approach encompasses a higher predictive value and is in this respect more relevant for the users.

In contrast, the earnings figure stemming from full fair value accounting has a different information content. It is not a suitable base for extrapolating future earnings, instead informing the users about the entity’s ability to deal with risks. Therefore, accounting information derived through full fair value accounting is of limited relevance. This also holds true in respect of the stewardship function of financial statements, which is not considered in adequate depth in the discussion paper. Fluctuations of market prices are caused by several factors. Only some of them reflect the performance of management. In this context, it has to be borne in mind, that users of financial statements are not interested in the cash flows stemming from individual assets or liabilities, but in the cash flows of the entity as a whole.

Because of the above factors, we would like to propose the Board to carry out in-depth research to develop a consistent framework for a concept of performance measurement – in the context of the comprehensive research project mentioned in our general remarks – before deciding on the measurement concept for initial accounting. Neither the Board nor accounting theory have up to now provided a framework that fulfils these requirements and is in addition practicable. Concepts that have proved to be useful in finance theory are not automatically suitable for accounting purposes.

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.

(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)?

a) Both, this question and the chapter it is referring to have a fundamental weakness: they mix the objective and the (possible) instruments to reach that objective, as already mentioned in our general remarks. In our opinion, the arguments supporting the purported superior information value attaching to market prices and fair values respectively are not persuasive. In paragraphs 54 – 56 of the discussion paper, the authors adapt findings from finance theory, the theory of (nearly) perfect and complete markets, without justifying its validity for accounting purposes. Not surprisingly, the conclusions derived on this basis do not hold true. The arguments set forth to support the superiority of fair value are only valid under the idealised conditions associated with perfect and complete markets.

But in reality, perfect and complete markets do not exist, as already mentioned in our general remarks. In practice, the assumptions concerning (nearly) perfect and complete markets appear to be valid only for certain financial instruments traded on highly liquid markets. In particular, for most of the assets and liabilities outside of the finance industry there are no market prices that fulfil the assumptions that are essential for the defined market value measurement “objective”. When there are no actual market prices stemming from perfect and complete markets, market price estimates cannot reflect the expectations and risk preferences of all market participants, condensed to a single price that can be expected to earn the current rate of return available in the marketplace for commensurate risk at the measurement date. Instead, prices stemming from imperfect markets merely reflect the expectations of the individuals carrying out the transaction.

Fair values derived through valuation techniques in the absence of observable market prices reflect subjective assumptions to an even greater extent. In our opinion, fair value lacks the qualitative characteristic of relevance in such cases, because users of financial statements are not able to understand the implications of the assumptions for the fair value and therefore are not able to assess timing and uncertainty of future cash flows from those assets or liabilities.

b) The proposed definition of “market” is the essential prerequisite for the information value of market prices, which is necessary to maintain the thesis of the superiority of fair value measurement, but, in our opinion, such markets often do not exist. The fact that the assertion of the existence of an exclusive market value is not valid is admitted in paragraph 63 of the condensed version and paragraph 136 of the long version of the discussion paper, so that the paper itself is contradictory.

c) We reject the assertion made in paragraph 102 of the discussion paper claiming fair value is more relevant, as long as it can be reliably measured. This assertion is wrongly denominated as the conclusion of chapter 4, but it is neither derived from convincing arguments nor is it true.

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.

Again, this question is referring to attributes rather than objectives. We agree with the discussion of the attributes of entity-specific measurement concepts as set out in paragraph 57 - 58 of the discussion paper; namely, that such measurements can be more useful to investors than market values, because they express management's expectations about the future cash flows the entity can generate through realising its competitive advantages that are not reflected in market prices. Thus, their relevance will be superior, provided they are also sufficiently reliable, because they incorporate information about the value of an item, which is only realisable through its entity-specific use.

In this context we would like to mention that we appreciate the Board recognizing the value of entity-specific information through favouring the management approach for segment reporting, as set out in its exposure draft ED 8 Operating Segments published in January 2006. However, we do have some concerns regarding certain details of ED 8, which we explain in more detail in our separate comment letter referring to this subject.

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 table set forth in paragraph 59 reveals a weakness of the discussion paper which we have previously mentioned: it confuses the means to reach the objectives with the objectives themselves. Whereas the left column depicts the objectives of financial accounting (and the qualitative characteristics), the headline purports to depict objectives, too. Instead, the market versus entity-specific distinction just applies to certain attributes of measurement concepts. In this context, we wonder why the qualitative characteristic reliability is missing in the table. Furthermore, we wish to state that none of the discussed measurement concepts can be allotted solely to one of these categories. This would result in a severe oversimplification.

Not surprisingly, the assertion made in paragraph 60 of the discussion paper about the general superiority of market-specific measurement concepts, i.e. fair value, is not derived from persuading arguments. Consequently, we reject the proposed assertion of the overall superiority of fair value measurement for assets and liabilities on 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.

(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.

a) The notion that there can be only one market (fair) value for an asset or liability on any given measurement date is appropriate only in the case of perfect and complete markets. In reality, most of the markets are imperfect. Even markets for financial instruments frequently do not reflect the equilibrium price as defined in paragraph 55 of the discussion paper, as proved by behavioural finance theory. Therefore, as admitted in paragraph 63 of the condensed version and paragraph 136 of the long version of the discussion paper, market inefficiencies necessarily rebut the assertion of the existence of an exclusive market value. This is acknowledged in the discussion paper through its discussion of transaction costs in paragraphs 86 - 87 and paragraphs 193 - 200 of the long version.

The fact, that the existence of more than one market price calls into question the main conclusion of the discussion paper, the purported superiority of fair value. It is not possible to determine an unambiguous value through the use of a market price. Therefore some kind of valuation techniques have to be used, thus impairing both, relevance and reliability of fair value.

b) In our opinion, measurement on initial recognition should not only be based on the market in which the asset was acquired, but on the very transaction, through which it was acquired. There is no reasonable basis to support the implicit assumption that management manipulates the bases for initial measurement through acquiring assets for higher prices than necessary without any economic reason. In addition, it will be impractical to determine whether an entity actually acquired an asset in the most advantageous market available to it. This requirement would impose severe restrictions on the verifiability of the measurement.

When the actual transaction price is used as measurement base on initial recognition, there is no need for additional guidance specifying rules on how to determine the most advantageous market price in multiple markets.

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.

Under the presumption that fair value is defined as an exit value (see paragraph 86 of the discussion paper), without taking into account transaction costs, we agree that a promise to pay has the same fair value on initial recognition irrespective 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. However, in our opinion, fair value per se is not the relevant measure at initial recognition, but rather historical cost, as already mentioned in our general remarks. Nevertheless, we concede, that in the case of promises to pay historical cost normally will equal fair value, plus/minus transaction costs, on initial recognition. But this measurement does not prejudice fair value based measurement of liabilities at subsequent balance sheet dates. As we have previously explained in our comment letter on Financial Instruments – Proposed Amendments to IAS 32 and IAS 39 dated 11 October 2002 – we are concerned about the effects of accounting for an entity’s own credit risk, and in particular that any change in a debtor’s creditworthiness could result in the recognition of a gain or loss by that debtor. The users of financial statements would perceive this as confusing and counterintuitive rather than as a relevant information.

In addition, changes in the credit standing of an entity are usually accompanied by adverse changes in the value of the entity's internally generated intangible assets (in particular, internal goodwill). However, these adverse changes are not recorded. Thus, there is a fundamental inconsistency and "mis-matching" in reporting the effects of changes in credit standing on an entity's liabilities. While a deterioration of the creditworthiness causes a reportable gain from the decrease of the fair value of the entity's liabilities, a loss from the corresponding decline of internal goodwill is ignored.

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.

Because the discussion paper does not set out a comprehensive concept about which view of the entity's financial performance and financial position the authors believe the financial statements should portray, it is difficult to assess whether the suggested definitions are suitable for improving the quality of financial statements. Nevertheless, we want to point out some problems we have identified:

a) Whether it is appropriate to use the unit of account in which an entity acquires an asset or incurs a liability for initial recognition, depends on the intended use, i.e., on entity-specific assumptions. For example, if an entity buys a portfolio of assets with the intention of holding that portfolio largely intact and then selling it, it seems reasonable that the unit of account on initial recognition and subsequently should be the portfolio of assets. On the other hand, if the entity is acquiring individual assets, bundling them together and selling them as portfolios (or buying portfolios, unbundling them and selling individual instruments), the proposed definition of unit of account (the unit of account in which the reporting entity has acquired the asset or incurred the liability) will defer the profit or loss resulting from the bundling/unbundling, which seems to be appropriate.

b) The requirement proposed in paragraph 73 of the discussion paper defining the appropriate unit of account for non-contractual assets on initial recognition being the lowest level of aggregation at which an identifiable asset is ready to contribute to the generation of future cash flows is imprecise. It leaves open what is meant by a contribution to the generation of future cash flows. At least beginning from the level of a cash generating unit, all assets and liabilities somehow contribute to future cash flows. Therefore, more detailed guidance is desirable on this subject.

These specifications may have confirmed the importance of further research and discussion on the subject of adequate measurement concepts for initial recognition in tight connection with re-measurement because of the significant interdependencies.

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.

In our opinion, further in-depth research has to be done on the topics covered by this question and the respective part of the discussion paper. In our view these deliberations are based on findings from finance theory (the theory of perfect and complete markets), that are not valid for the purposes of accounting.

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.

Again, we find it difficult to comment on this issue, because there is no comprehensive concept about which view of the entity's financial performance and financial position the authors believe the financial statements should portray and, furthermore, the definition of fair value in paragraph 46 is not clear, as already mentioned in our answer to question 2.

If the suggested definition of transaction costs were incorporated in a standard, it would be necessary to provide additional guidance on how to distinguish transaction costs from those costs incurred by an entity to acquire an asset, or when incurring a liability, that can be recovered in the market.

In our opinion, when fair value is considered as a measurement concept on initial recognition, it seems to be sensible to include in fair value all those costs, that usually are included in the market prices. Generally this will also be the case for those costs that all market participants of the relevant market would have to incur. The definition of transaction costs (paragraph 86) distinguishes between transaction costs and costs that can be recovered in the market. This may have a similar meaning, but this is not clear to us.

In any case, transaction costs in their normal sense should be included in the measurement concept for initial recognition, for the following reasons: When, for example, an entity acquires an asset which it intends to use until it is exhausted, the entity is concerned only about the total cost of that asset and the return it will realise from it. Which part of the costs incurred constitute transaction costs is not relevant, neither for the entity, nor for the users of the financial statement.

Therefore, the information provided by measurement of a non-financial asset at fair value is relevant only when the entity either intends to sell that asset in the near future, or could be forced to sell the asset, should it experience serious financial difficulties.

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.

In our opinion, from a theoretical point of view, it is possible to solve the problem of balancing relevance and reliability by defining a minimum level for reliability and optimizing relevance. The most challenging issue in this respect will be to define an acceptable level of reliability and to test which measurement concepts fulfil the requirement. When selecting the most suitable measurement concept for initial recognition it has to be borne in mind that fair value has a very high degree of reliability only in those rare cases, where an active market exists. In all other cases the degree of reliability is impaired by several factors.

We would like to explain the limitations on the reliability of fair value on the basis of the existing rules.

- First, the definition of an active market is not unambiguous. It is not clear how to measure the liquidity of a market and which threshold to use in judging a particular case.
- Second, in those cases where fair value has to be derived from the prices of similar assets, the requirements for assets being similar are as cloudy as how to modify the prices without recourse to model-based calculations.
- Third, reliability of fair value is severely impaired when it has to be calculated through using valuation techniques. This is already true in those cases where market prices are available as parameter values, and become even more relevant, where this is not the case. The latter is quite common.

We believe that these limitations on the reliability of fair value apply equally to the concept of fair value on initial recognition, as set out in the discussion paper; all the more so, as the requirements of “market”, as defined in the discussion paper (see paragraph 105) are quite strict. In consequence, fair value on initial recognition will stem from the use of valuation techniques, based on “non-market” parameter values in many cases, thus failing to provide an acceptable level of reliability. We wonder, why the reliability limitations mentioned in paragraphs 103 - 104 of the discussion paper, and their consequences for the applicability of fair value on initial recognition have not been analysed in more detail.

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 admit that estimation uncertainty and economic indeterminacy are important aspects when discussing measurement reliability. But we would like to call attention to some important issues, that are not discussed in adequate depth in the discussion paper. Firstly, we would like to point to the fact that in relation to reliable measurements the main issue is not the level of uncertainty or risk, but the degree of measurement imprecision associated with a required or desired level of confidence or risk (e.g., if the applicable accounting standards require a statistical threshold such as "probable"). In other words, the discussion paper does not appear to appropriately distinguish between the required or desired statistical confidence (measurement risk) associated with a particular confidence interval (measurement precision). For this reason, we suggest clearly distinguishing between measurement imprecision and measurement risk or uncertainty when discussing measurement reliability.

Moreover, we would like to point out that there is a substantial difference between estimation uncertainty and economic indeterminacy. Whereas estimation uncertainty is merely capable of elimination through disclosures, this is possible for economic indetermacy: for example, in the case economic indetermacy is solved through allocations, as mentioned in paragraph 95 of the discussion paper, disclosing the allocation method and formula will alleviate the limitation on relevance and reliability of measurement considerably.

Furthermore, we would like to draw attention to the fact that it is difficult to define which information on measurement uncertainty the users of financial statements will need in their respective cases. Even when entities succeed in describing the nature and extent of measurement uncertainty, it may be difficult for the users of financial statements to understand the explanations and draw conclusions there from about timing and uncertainty of future cash flows.

Finally, we are not convinced, why the discussion paper narrows the concept of reliability to “faithful representation”, which is in contrast to the Framework (paragraph 31) and the discussion paper itself (paragraph 16). In addition, in our opinion, estimation uncertainty and economic indeterminacy do not only pertain to reliability but also relevance. We encourage a discussion concerning the latter.

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.

We strongly disagree with this position, for the following reasons:

- As we have discussed above, except for some classes of assets and liabilities, in particular financial instruments traded on active markets, the reliability of fair value is impaired.
- Furthermore, in the absence of (nearly) perfect and complete markets, the relevance of fair value has to be questioned, as already discussed in more detail in our general remarks and answers to question 4 and 5. For most of

the non-financial assets and liabilities fair value does not comprise information about the intended entity-specific use. In contrast, historical cost measurements do in fact incorporate prices resulting from transactions, depicting management's own expectations to the extent that they are proven valuable in executing the market transaction. Historical cost can therefore be seen as the minimum quantification of the value in use. Thus historical cost is more relevant to users of financial statements and, at the same time, in all of those cases more reliable than fair value where fair value is not derived from an active market.

- Another important topic not analysed in appropriate depth in the discussion paper is the cost-benefit-constraint: using fair value instead of historical cost on initial recognition would increase the cost of preparing financial statements considerably. Because historical cost has to be determined and considered in accounting anyway, e.g. simply by monitoring payment, the determination of fair value necessary under the model proposed by the discussion paper is always an additional step to be carried out by the entity. According to our view there is no corresponding additional benefit for the users of financial statements which might match the additional costs. On the contrary, in our opinion, using fair value as preferred measurement concept on initial recognition would result in a diminished degree of reliability and relevance compared with historical cost.

Thus, there are strong arguments for refraining from considering fair value as the most relevant measure of assets and liabilities on initial recognition of assets and liabilities, irrespective of the circumstances.

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 agree that fair value is not capable of reliable estimation in common situations on initial recognition (p. 104).

In paragraph 106 the discussion paper reasons that one observable transaction or a few infrequent transactions does not necessarily constitute a market. It is suggested that a transaction price paid or received for an asset or liability should not be described as its fair value on initial recognition unless there is persuasive evidence that it does have the essential properties of market value. In contrast, the commonly used assumption that the transaction price of an asset or liability arrived at between a buyer and a seller dealing at arm’s length should be presumed to be its market price at the date of the transaction, unless there is convincing evidence to the contrary, is rebutted (paragraph 107).These arguments have some merits. But we question whether the consequences are considered in adequate depth. The requirement to deliver persuasive evidence for a transaction price having the essential properties of market prices in the case fair value where used as measurement concept on initial recognition will cause considerable additional cost in preparing financial statements. This can be avoided quite easily through the use of historical cost.

Moreover, such a requirement will impair both the relevance and reliability of fair value in accounting practice, because it will reduce the cases where values stemming from market transactions may be used. Instead, substitute values will be used. When substitutes are calculated through the use of valuation techniques, there is considerable room for discretion, owing to the relevant underlying assumptions and estimates.

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 realizable 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)?

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.

We strongly reject the conclusions on the comparative relevance and reliability of historical cost. Paragraph 121 of the discussion paper argues, that it "cannot be presumed that the price paid is recoverable in the market place without independent substantiation". Therefore, relevance of historical cost is supposed to be less than fair value. But, as already mentioned when answering question 11, for assets intended for use in the entity instead of selling them immediately, it is not relevant whether the incurred costs would be recoverable through immediate sale, i.e. third parties would be willing to pay the same price. Thus, there is neither a need for an additional "market-test" for prices resulting from market transactions nor any impaired relevance resulting from the fact that historical cost does not purport to measure the value received.

On the contrary, the relevance of historical cost for initial recognition stems from the fact that it represents the minimum quantification of value in use, as viewed through the eyes of the management, and is also reliable, because it results from a market transaction. Therefore, the relevance of historical cost is higher than that of fair value.

We also reject the opinion set out in p. 124 of the discussion paper that matching of historical costs results in a less informative matching in later periods. At least compared with the information value resulting from using fair values that do not stem from active markets, matching of historical costs leads to more relevant financial statements.

We are not certain of the information value of distinguishing between net income effects resulting from activities relating to the acquisition or creation of an asset and those relating to subsequent activities on measurement in subsequent periods, which is purported to result from matching fair values, stemming from the use of fair value for initial recognition. Furthermore, the argument set forth relating to the matching principle could only be valid in discussing re-measurement.

We therefore would advise the Board to adhere to historical cost as the measurement concept on initial recognition, because it is a relevant and reliable measure if applied in accordance with generally accepted accounting principles. It is also supported by extensive practical experience, and both entities and the users of financial statements are familiar with historical cost based financial information.

Likewise, we reject the conclusion set out in paragraph 165 of the discussion paper, asserting value in use being less relevant than fair value. In the contrary, as already mentioned in our general remarks, in our opinion, for non-financial assets and liabilities value in use is more relevant than fair value, provided that it is based on management's expectations. Therefore, there is not only no need for an adoption of value in use in order to be as consistent as possible with the fair value measurement concept (p. 166), such an adoption would severely impair the relevance of value in use. We have to admit, however, that restrictions concerning the reliability of value in use in some circumstances necessitate falling back to a suitable substitute, which is historical cost.

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.

From a conceptual point of view, it is sensible to apply the same measurement objective to the substitute of a measurement concept as to the measurement concept itself. But we would like to reiterate our contention that the Board should refrain from requiring fair value as the measurement concept on initial recognition.

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.

Again we find it difficult to comment on this issue, because there is no comprehensive concept about which view of the entity's financial performance and financial position the authors believe the financial statements should portray and, furthermore, the definition of fair value in paragraph 46 is not clear, as already mentioned in our answer to question 2.

We would also like to note that we are not convinced as to why current cost (level 3 of the hierarchy) should be capable of reliable estimation in cases where fair value of an item cannot be reliably measured through valuation techniques, all the more as the discussion paper admits, "that, for practical purposes, historical cost measurement might be accepted in lieu of current cost on initial recognition of an asset or li-

INSTITUT DER WIRTSCHAFTSPRÜFER IDW

ability absent persuasive evidence that a reliable measurement of current cost is practicable and would differ significantly from historical cost” (paragraph 185).

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.

We are concerned about the possible implications of the presumption the discussion paper establishes for the date of initial recognition (paragraphs 179 – 180), especially when fair value is deemed to be the preferred measurement concept. For example, if prices change between the date when a fixed cash price is negotiated and the initial recognition of the asset acquired, then the asset would be measured based on prices at the later date. In many cases, this will lead to a difference in the fair value at contract date compared to the date when the asset becomes ready to contribute to the generation of future cash flows. This difference will be reflected in profit or loss. We are not convinced about the information value of this treatment, whereas we are concerned about the measurement uncertainty involved in the determination of the fair value on the defined date of initial recognition. In contrast, the use of historical cost which have been determined at the contract date avoids this uncertainty. Furthermore, the lack of clarity of the notion “when the asset becomes ready to contribute to the generation of future cash flows”, which defines the point in time of initial recognition, provides an opportunity for management to exercise discretion, particularly for self constructed assets.

Yours sincerely

Wolfgang Schaum
Executive Officer

Norbert Breker
Technical Director
Accounting and Auditing