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Director, Accounting Standards
Canadian Accounting Standards Board
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Dear Sir,

RE: MEASUREMENT ON INITIAL RECOGNITION

UNICE welcomes the opportunity to comment on the IASB discussion paper "Measurement bases for financial accounting – Measurement on initial recognition", prepared by staff of the Canadian Accounting Standards Board (CASB).

We acknowledge that the paper contains some very thorough analyses, and are grateful to the authors to have undertaken such a difficult project. However we regret that this discussion paper, announced and first discussed in 2003, comes as a great disappointment to us. It indeed fails to respond or to deal with issues which in our view need to be addressed before a wide and open debate on measurement, and more particularly on fair value, can take place.

1- *Restricting the analysis to initial recognition fails to encompass the most critical issues associated with fair value measurements, in particular timing and scope of profit and loss recognition*

The scope of the paper, limited to initial recognition, has come as a surprise to us. The authors acknowledge that subsequent measurement considerations may override the conclusions that they reach in this first step. They do not comment however on the expected benefits from such limitations.

We believe that measuring assets and liabilities at fair value, either upon initial recognition or subsequent measurement, raise the issue of when gains and losses ought to be recognised and what recognised gains and losses are meant to portray.

We observe that there is no insight into what the authors believe the financial position and performance of an entity should reflect. Such an insight seems to us essential to understand how and why fair value would appear to be the most relevant measurement basis, if reliably measurable. Therefore starting the discussion with measurement at initial recognition is not the first step to be taken – although it might seem so at first glance. Before dealing with initial recognition a discussion on the objectives and purposes of financial reporting including the relevant addressees and the theoretical and practical implications of such an approach must take place. Interdependencies between (i) the underlying assumptions, (ii) measurement at initial recognition, and (iii)

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subsequent measurement must be taken into account from the very beginning of the discussion.
We therefore believe that the first consultation step in the fair value measurement debate has missed the opportunity to launch the heart of the debate. We believe a second discussion paper will be necessary in order to address such fundamentals.

2- *Support for market value measurement objectives is not substantiated by any argument and relies on unconvincing assertions. Moreover entity specific measurement objectives are turned down on erroneous assumptions.*
Even after a close reading of the full version of the paper, we have not been able to find any argument supporting market value measurement objectives. The only argument put forward is that "the market value measurement objective is reasoned from finance literature on market prices and efficient markets" (par. 54). There is no indication why such a foundation makes it suitable for financial measurement purposes. No market on which entities operate all around the world is perfectly efficient. It is therefore difficult to understand how a market value measurement objective justified solely by finance theory would help prepare fair and useful financial statements of entities which operate in a real-life economic world far from meeting the underlying finance theory assumption that markets are fully efficient. If there are valid arguments to support the market value measurement objective, they are still to be developed and presented.
We disagree with the definition of entity-specific measurement objectives and also with the argument put forward to turn them down. In our view, entity-specific measurement objectives are not necessarily driven by management's intentions. Nor would they be justified by management being expected to meet forecasts. Management is held responsible by investors for the overall profitability and cash generation achieved, in comparison to other potential investments involving the same risk. We doubt that this overall profitability is best featured by measuring against market (most of the time hypothetical) each single transaction the entity enters into, since most of the resulting gains and losses are either not realizable or never to be turned into cash. We believe entity-specific measures are likely to embody in assets and liabilities future cash in- and out-flows reflecting expected outcomes of transactions. As a result, they have a high degree of predictive value. They indeed reflect the specific knowledge that management has of the entity's strengths and weaknesses and tend to increase financial statements predictive value. They embody in asset and liability valuations information which is unavailable to the public and hence enhance financial reporting decision usefulness.
We have carefully considered the table in which characteristics of market value versus entity-specific measurement objectives are meant to be compared. The content in the table remains merely descriptive, without any analysis of how the described characteristics would relate to financial reporting efficiency.
Furthermore we observe that the authors run into some contradictions in chapter 5 when attempting at implementing market value measurements objectives. The authors indeed acknowledge that real economic life contradicts the theoretical expectation that there would be one single price for each asset

and liability. The fact that more than one fair (market) value for the same asset or liability exists (or at least can exist), fundamentally contradicts the concept of superiority of fair values with regards to relevance and reliability. If there is more than one fair value, then the decision which one to choose can only be based on convention (either exit/entry or most favourable market etc.). Those in favour of fair values like to give the impression that the fair value is the only "correct" or "real" value. Here it is easy to see that this is not true and therefore these assumptions should be handled with caution.

Market inefficiencies are mentioned as playing a role (end of par. 63), however are not considered after that. As a result conclusions drawn are not consistent with observable practice, in particular in respect of transaction costs. Also, the influence and significance of value affecting properties, well emphasised in the paper, imply in our view that they be selected from the entity's perspective, in accordance with the entity's business model and the choices made by the entity in the conduct of its operations. Any selection or valuation made from the point of view of "any" market participant would not be relevant, as it would tell a different story from the entity's.

3- *The use of fair value is limited to assets and liabilities which can be estimated on the basis of market inputs only. It is however difficult to see where the limit would lie in practice.*
The discussion paper strongly rejects the presumption that any transaction price is fair value. Arguments developed to support such a rejection are completely consistent with finance theory on which the entire proposed approach has been developed. Although we have denied that finance theory is always applicable for financial reporting purposes, we have been interested in the authors' statement, as it comes in strong opposition to FASB and IASB's approach to fair value. Many commentators in their answers to Business Combinations phase II exposure drafts have pointed out the inconsistency contained in the joint proposals: first, they have argued that the agreed transaction price was likely not to equal the fair value of the acquiree (in a bid for example, the transaction price is no equilibrium price resulting from competitive forces but the price high enough to bid out competitors; most of the time, the acquirer incurs total acquisition costs justified by the synergies that it only can value); second, they have not been able to reconcile how the fair value of the acquiree could be reliably measurable while an excess payment failed the necessary reliability threshold for recognition. Third, they have made it adamantly clear that in most cases the total acquisition cost was recoverable (necessarily from the market, there is nowhere else to operate).
We wonder whether the authors share the views of these commentators, as business combinations are particularly unique transactions, or whether we fail to grasp in what conditions and circumstances fair value would not be reliably determinable.
Although an entire chapter has been devoted to reliability concerns, no principle has been proposed which could serve as a basis to determine "the acceptable level of reliability". Moreover, in spite of our agreement with the analysis of

uncertainty and of economic indeterminacy, we are concerned and therefore recommend that the following guidelines be retained:

- no measurement basis can be relevant if it cannot be measured reliably,
- disclosures cannot cope with a lack of reliability,
- an acceptable level of reliability can be reached if and only if what the asset or liability purports to portray is the future cash in- or out-flow expected to arise, not a representation of future cash flows based on assumptions estranged to the entity's business model and market of operations.

4- *The paper excludes transaction costs from fair value. We disagree with the definition proposed and implied consequences.*

As we have noted earlier, the authors have referred to the existence of market inefficiencies, before dismissing them from the analysis. We believe that transaction costs are often incurred in order to counterbalance some market inefficiencies. As such, they should not be separated from the purchase price, as incurring those costs is likely to have an impact on the price finally agreed.

The paper defines transaction costs as the costs that would not be "recoverable in the marketplace on the measurement date". Recoverability is not further defined; however the example given refers to the price that would be obtained, would the asset be sold to a third party right after purchase. We understand recoverability as meaning that cash invested in the operation will be at least fully recovered, showing that the transaction results in due course in a net inflow to the business. Recoverability cannot be assessed only on the basis of exchange transactions, but also on in-use consumption. We also dismiss the market on which the asset could be *re-sold* as being relevant. In many cases, prices vary whether the asset is purchased new from the producer, or bought on the "used" market. Cars are an excellent and easy example to illustrate the phenomenon.

As a result, we believe that transaction costs are part of the value to the business, as long as the total acquisition cost incurred is recoverable, whether recoverability is warranted by intended use or fair value less costs to sell.

5- *Strengths and weaknesses of potential substitutes for fair value do not seem analyzed in a neutral fashion. We disagree with the case made against historical cost, in particular in the context of initial recognition.*

Chapter 7 which analyses alternative measurement bases to fair value does not add much value to the discussion paper. This chapter could have been meant to illustrate how each measurement basis was likely to best serve decision usefulness and predictive value, and how and why it could be impeded from doing so. Rather it indicates differences between each measurement basis and fair value, each difference being regarded as a weakness. There is therefore no least chance that "factors might overturn the tentative conclusion… that fair value is the preferred measurement basis…"(par. 119 (a)).

Moreover we disagree with the case made against historical cost, especially in the context of initial recognition. If a company pays a certain amount for an

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asset, it expects at least the same cash flows in the future, and consequently this is the fair value at initial recognition. Although we acknowledge that allocation of cost processes create what authors have named "economic undeterminacy", we disagree with the idea that cost allocation processes would be such that historical cost could lack representational faithfulness (par.130-131). Cost allocation processes are based and justified on acceptable rationale. They belong in our view to the art of modelling, so widely in use to approximate fair value, (and so much needed to approximate other measurement bases consistently with market value measurement objectives). We also object to the argument that historical cost would – intrinsically - lack reliability because pre-recognition costs are not capitalised in accordance with existing IFRS (par.132). Amendments to existing IFRS can be valuably recommended, if deemed so. Finally we fail to see why recoverability of an asset would be more difficult to determine when the asset is measured at cost than when it is measured on another basis (par.133).

As a result of the above comments, we believe the IASB is due to work on another discussion paper which would supplement the Canadian paper on all issues addressed above. Without such an effort, the long awaited wide and open debate on fair value will not take place.

Should you wish to comment on the above further, please do not hesitate to contact us (jpc@unice.be).

Yours sincerely,

J. Chau

(original signed by)
Jérôme P. Chauvin
Director, Legal Affairs Department