CIPFA

Our Ref Tech4/LC/SC0030

Director, Accounting Standards
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Dear Sir/Madam

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

CIPFA welcomes the publication of this paper, which is a very useful development in the global debate on the key issue of measurement. We are pleased to present our comments on the discussion paper, which has been considered by CIPFA's Accounting and Auditing Standards Panel.

Our general observations and discussion of key matters are set out below. Answers to the questions in the Invitation to Comment are attached at Annex A.

Wider context

As the paper notes, initial recognition is only one part of measurement discussions. To determine the full implications of a choice of measurement base requires consideration of subsequent remeasurement, performance measurement, and capital maintenance. Furthermore, radical changes to a measurement base may warrant rather different presentation in primary statements and explanatory notes. In developing our response to the discussion paper we have necessarily given some consideration to wider issues, particularly those relating to remeasurement.

Consideration of a move away from Historical Cost

CIPFA welcomes the paper's development of a principled and coherent approach to measurement on initial recognition, which we hope will provide constructive input to subsequent discussions on other aspects of measurement.

We agree with the paper's observation that there are significant problems with the use of historical cost in certain circumstances. Many frameworks grounded in historical cost treat these as special cases, applying different measurement criteria in specific instances such as finance leases, or using subsequent remeasurement as a corrective.

We agree with the paper's observation that historical cost will equate to fair value under certain circumstances (subject to exclusion of transaction costs, an issues which we discuss separately).

Leaving aside the cases of 'significant problems' and 'equality', there is a third category of recognition, where there is a difference between fair value and historical cost, but this is not of an order which suggests that the use of historical cost is not meaningful. Sometimes the difference between fair value and historical cost will be very small, and if measurements are considered in aggregate, the difference will be proportionately smaller.

We consider that this third category of measurements is numerically significant, and probably predominant. Furthermore, the benefits of adopting a current value or fair value measurement objective to such transactions at initial recognition are difficult to assess, and might easily be less than the costs of obtaining and processing sufficiently reliable fair value information where such information is available. The determination of whether reliable information is available also has a cost.

Given this, we think it is highly likely that, notwithstanding the possible superiority of fair value or other current value measurement bases in principle, it would not be appropriate to apply such bases comprehensively in financial reporting standards, because

- In some cases, identifying a reliable candidate for fair value will not be possible; and
- For large classes of transactions, the benefit received from information on a fair value basis would be exceeded by the cost of reliable measurement and associated information processing

The above reasoning may justify financial reporting standards which continue to apply historical cost, with piecemeal corrections in certain well defined situations. However, we do not consider that the need for pragmatism in standard setting detracts from the development of a more principled and consistent basis in conceptual discussion documents, such as the discussion paper. Indeed, such an approach may prove more helpful when subsequent consideration is given to matters such as re-measurement.

Use of Entry Values

We would like to register our very strong agreement with the view that, if a measurement base other than historical cost is chosen, it will normally be appropriate to use entry rather than exit values. One of CIPFA’s major concerns in previous discussions of fair value has been that, particularly for specialised and non-income generating assets, exit values may provide information which is of negligible use in decision making.

Current Value

The paper suggests that valuations which are current are more decision-useful than those which reflect historical information, even at initial recognition.

CIPFA agrees that, in principle, current value will be more decision useful, although the benefits are normally less clear at initial recognition than at subsequent measurement stages.

As noted above, in many cases the cost of current accounting at valuation may outweigh the benefits to readers of accounts. It might therefore sometimes be better to defer the use of current value until subsequent remeasurement stages. There may also be classes of assets and liabilities for which the cost of producing reliable information will always exceed the associated benefits.

Fair Value and Deprival Value Hierarchies

The paper proposes a hierarchy which promotes market based fair value over entity-specific valuations, and suggests that this is a development and improvement of the deprival value model used, for example, in financial reporting standards developed by the United Kingdom Accounting Standards Board.

Given that the paper allows the use of entry values, the principal differences between the models are:

— the market based fair value model proposes an explicit hierarchy based on the availability of reliable information, whereas the deprival value model has an implicit hierarchy based on the relative value of component measures

— the market based fair value model excludes transaction costs, whereas deprival models include them

We are broadly content with the market based hierarchy. We are not completely clear about how the hierarchy would operate in practice, as the level of required reliability has not been discussed. It could well operate in a manner which correlates with our view as to when information is relevant. Also, because that the model is based on entry values, the transition between different levels of the hierarchy is likely to be less problematic, and is less likely to promote the use of information which would be irrelevant to decision making.

Transaction Costs

We disagree with the exclusion of transaction costs from the measurement base for initial recognition. In our view this makes the market based fair value model less relevant. Our disagreement reflects the fact that under a market based measurement objective, markets are aware of transaction costs which all market participants are subject to, and will factor these into the market price for an asset. We explore this in our response to Question 16, where we also disagree with the worked example at 397 which promotes fair value as a better measure of "the market view of value in use" than deprival value.

Furthermore, as noted below, we are of the view that the case for a market based measurement objective has not been fully proven. Under an entity specific view, it would be appropriate to include entity specific transaction costs (rather than using these only as a proxy for market costs).

Market based measurement

The paper suggests that measurement based on market information, where reliable information is available, is superior to entity based measurement.

This may reflect generalisations of views grounded in idealised market situations, and it is not clear to us that applicability to real world situations has been demonstrated. The question as to when information is 'sufficiently reliable' also warrants further consideration.

However, both this question and that of transaction costs are inextricably bound into the question as to how performance is measured and what it is intended to represent. In the absence of discussion of this issue we are unable to provide further comment.

Overall Conclusion

The discussion paper promotes as superior for initial recognition purposes, a particular definition of Fair Value, with a backup hierarchy of alternative measures. This proposal is supported by analysis which is useful in many regards, and we hope this will help further discussion.

Because the approach taken allows for the use of Entry Value, CIPFA was hopeful that this might support the development of 'for profit' measurement which could be adapted without severe anomaly to a 'public benefit' context.

However, in looking at the reasoning as presented for 'for profit' entities, we disagree with some of the analysis as it applies to inefficient markets, and consider that other aspects of the analysis are inconclusive, rather than definitive.

As a result, the effect of our consideration of the paper has been to reinforce our support of 'deprival value' as a basis for measurement for 'for profit' entities, subject to restrictions on the use of current value on cost benefit grounds. Although normally expressed in rather different terms, this underlies the current interpretation of UK GAAP to the public benefit sector.

In summary

- we welcome certain aspects of the proposals which would ease adaptation of 'for profit' reporting standards to the 'public benefit' context

- however, we do not consider that the discussion paper makes a sufficiently convincing case for the use of its fair value model as an appropriate basis for 'for profit' activities in inefficient markets.

Yours sincerely

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CIPFA

DISCUSSION PAPER "MEASUREMENT BASES FOR FINANCIAL ACCOUNTING – MEASUREMENT ON INITIAL RECOGNITION"

19 MAY 2006

AT THE HEART OF PUBLIC SERVICES

CIPFA is one of the leading professional accountancy bodies in the UK and the only one which specialises in the public services. It is responsible for the education and training of professional accountants and for their regulation through the setting and monitoring of professional standards. Uniquely among the professional accountancy bodies in the UK, CIPFA has responsibility for setting accounting standards for a significant part of the economy, namely local government. CIPFA's members work (often at the most senior level) in public service bodies, in the national audit agencies and major accountancy firms. They are respected throughout for their high technical and ethical standards, and professional integrity. CIPFA also provides a range of high quality advisory, information, and training and consultancy services to public service organisations. As such, CIPFA is the leading independent commentator on managing and accounting for public money.

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Questions in the Invitation to Comment
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 this sets out the main measurement bases that should be considered.
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)?
It is useful to have working terms and definitions set out, especially in the light of the different interpretations in different contexts and jurisdictions. *In a more general context, some consider the term 'fair value' to be emotive and suggest that more neutral terminology should be used.* *We agree that the discussion paper sets out a consistent set of working terms and definitions, which closely reflects usage across various jurisdictions. Some definitions, including that for historical cost, are different from those used by the IASB. However, we have no observations to make on the technical use of defined terms in this 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 agree with the proposal that these are the two main sources of differences.

Questions in the Invitation to Comment
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)?**
We have no observations to make on the definitions. *We understand the descriptions of pricing and market mechanisms. We would note that such descriptions often reflect economic thinking initially framed in terms of quite idealised conditions, which might include perfect information, a lack of externalities, and an absence of transaction costs.* *The paper acknowledges the need for judgment and care in generalising results which apply to idealised markets. However, there will inevitably be debate on how effectively judgment has been exercised.*
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.
No. While we agree with some of the points made, the discussion provides a rather limited description of why the value of an asset to an entity might differ from its value to other entities. *Differences need not only reflect management intentions. They may instead reflect objective (and perhaps even well known) differences between the opportunities and synergies available to the different entities.*

Questions in the Invitation to Comment
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.
We do not agree with the comparison of market and entity-specific measurement objectives. *(a) The discussion of entity-specific measurement is over-simplified, characterising entity-specific measurement as subjective and non-standard. Substantial components of such measurement may be objective, and subject to audit verification. Furthermore, market information is often used to inform and improve entity specific measurement. Also in many jurisdictions (including the United Kingdom inasmuch as local GAAP applies) the scope for non-standard measurement is substantially limited by principles based financial reporting standards.* *(b) The discussion of market based measurement is over-simplified. For example, the assertion that market based measurements are understandable needs to reflect not only the measurement basis, but the scope of the measurement.* *We do not agree with the conclusion that market based measurement has superior qualities that make it more relevant: the conclusion does not appear to be fully argued. Furthermore, inasmuch as reasoning is provided, it seems to be couched in terms of suggestions that it is more objective and reliable, rather than more relevant.*

Questions in the Invitation to Comment
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.**
We agree that under specific idealised conditions, there could be only one market (fair) value for an asset or liability on a measurement date. *However, as the paper notes, in practice, matters are not so simple. While the factors at (i) and (ii) explain some of the differences, it is not clear whether these are comprehensive, or whether differences may arise for other reasons associated with inefficient markets.* *Given our response to other aspects of the discussion paper we are not sure that further research on this topic is necessary to inform the discussion of 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.
We agree with this analysis, subject to the discussion paper's definition of fair value, and its implied definition of market.

Questions in the Invitation to Comment
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.**
The proposals seem reasonable in isolation. However, the choice of measurement base for initial recognition is linked to a wider view of performance measurement. Choice of unit of account at particular recognition stages is in part a choice as to how gains are seen to crystallise from purchasing, construction or other performance. The discussion paper does not consider these wider issues.
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.
We strongly support the view that the best market source on initial recognition is the market in which the asset or liability being measured was acquired or issued. *We have not considered fully the other situations, which are less relevant to the specific circumstances we envisage being relevant to public benefit entities*

Questions in the Invitation to Comment
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.
The exclusion of transaction costs is consistent with the definition as proposed. *However, as discussed in the covering letter and our response to Question 16, we consider that the exclusion of transaction costs has the effect of making fair value information less decision useful and less relevant.*
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.
We agree with this proposal, although we note that the paper does not address the question of how an acceptable level of reliability might be determined.. *Also, we are concerned over the application of the proposal in the discussion paper: some of the reasoning in support of the 'relevance' of fair value seems to be couched in terms of 'reliability'.*
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 broadly agree with this analysis.

Questions in the Invitation to Comment
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 do not agree that fair value is the most relevant measure. *However, in the light of the discussion papers proposal that fair value will normally be considered by reference to 'entry' markets, our main disagreement is in connection with transaction costs. We consider that an approach similar to deprival value would be more relevant, and pursue this further in our answer to Question 16.*
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 there are some common situations in which fair value is not capable of reliable estimation. *We agree that single transaction exchange prices sometimes differ from market based fair value. We agree that where estimation techniques cannot be demonstrated to be consistent with market expectations, it is correspondingly more questionable that the derived estimates represent a good proxy for a market based fair value.* *Questions (a) and (b) seem to reflect a view that it is crucial to distinguish between 'market based' fair value and other valuations. We are not sure that this is the best approach, especially if there is an implication that entity based information is inferior.*

Questions in the Invitation to Comment
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)?** **(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.**
We have some minor concerns over the analysis of (a) to (d). *However, our principal concern is with the analysis of (e) deprival value.* *In our view:* • *the worked example at paragraph 397 is faulty. If restated this would provide more support for deprival value* • *the suggestion that deprival value is subject to the same problems as its components is over-simplistic. Although not as clearly described, the deprival model includes an implicit hierarchy of applicability of information, substantially underpinned by market based information where reliable information is available and relevant.* *In particular, the example at 397 suggests that:* *fair value = market view of value in use* *We would suggest instead that* *market view of total prior cost = market view of future value in use* *and that where there are transaction costs which are not incorporated in the market exchange price, these will result in a corresponding difference between fair value and the market view of value in use.* *(response continued on next page)*

Questions in the Invitation to Comment
Restating the worked example is not entirely trivial, as it does not include a value for the transaction costs to which market participants are exposed, which may differ from the specific costs borne by the entity. *However, in the case where the entity and market costs agree* *- the market view of value in use is 105* *- which exceeds net realisable value of 97, so that* *- recoverable value equals 105, so that* *- the lower of replacement cost (105) and recoverable value (105) is 105* *Thus, under these circumstances it is deprival value, rather than fair value which equates to the market view of value in use.* *Furthermore, even where the entity costs differ from the cost which other market participants might be expected to bear, it is clear that fair value systematically underestimates 'market ViU' by an amount corresponding to transaction costs.* *Given the above, it seems to us that deprival value is a more relevant measure, even when viewed in the light of market expectations.* *Having said this, if more developed arguments were presented to support the view that market based measures should be used where possible, it might be appropriate to adopt a 'fair value plus market expected transaction costs' base.*
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.
As noted above, we consider that there are problems with the adoption of a fair value approach as defined. *The question of whether a market based measurement objective should be predominant has also yet to be fully argued.* *Whatever over-arching basis of valuation is determined, it would be desirable to maximise consistency between stages in any application hierarchy, subject to considerations of the costs and benefits of the information so provided.*

Questions in the Invitation to Comment
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.
Notwithstanding our concerns over transaction costs, we are broadly happy with the hierarchy as articulated.
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 have no comments to make other than those included in our covering letter and the answers to specific questions.