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Dear Sir / Madam

Discussion paper „Measurement Bases for Financial Accounting – Measurement on Initial Recognition"

On behalf of The Institute of State Authorized Public Accountants in Denmark (FSR), we are pleased to comment on your discussion paper regarding "Measurement Bases for Financial Accounting – Measurement on Initial Recognition".

Introduction

We believe that any current project dealing with the measurement bases relating to elements of the financial statements in advance of the finalisation of the joint conceptual framework project of the International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards Board (FASB) is premature.

We have therefore, as an introduction to our answers to the discussion paper, described our views on the fair value principle and the application hereof.

Development in recent years

In recent years the standard setters have gradually been moving from the historical cost principle to the fair value principle. This change is presumably based on the desire for accounting and financial reporting to be in accordance with the classic economic theory.

The classic economic theory is based on several assumptions, which should be fulfilled before the theory can be applied. The most important of these assumptions is the condition regarding the existence of perfect and complete markets, i.e. the assumption that there exists an active market for each asset and liability and that it is not possible for any individual to obtain a higher profit of investments than any other market participant (no arbitrage). This also implies that all measurement should be additive, i.e. that the value of the individual assets can be aggregated and that the accumulated value equals the fair value of the total investment. In the classic economic theory it is therefore not possible to obtain a bargain deal or perform an overpayment for an asset or liability.

Overall views on fair value

FSR is generally sceptical about requiring application of fair value based accounting on a larger scale compared to cost based accounting. The primary reason for our scepticism is that the debate, in our opinion, is lacking a general debate about the purpose of the financial statement. And this debate must be finalized before any measurement bases can be recommended. Moreover, the above described assumptions for applying fair value can only be fulfilled in the real economies in very rare cases.

In our view only very few markets for assets fulfil the assumptions of being both complete and perfect. Examples of such markets are currency markets for USD and EUR, where the prices are the same for each investor and are additive. By contrast, an example of a market that is not perfect and complete is a market for a Company manufacturing machinery. Even if perfect and complete markets existed, the measurement of the manufacturing machinery would not be additive as the use of these machineries will result in synergies for the enterprise. It will therefore not be possible to measure the value of an enterprise by measuring the value of each asset and liability unless the synergies between assets etc. are taken into account. Furthermore, the synergies can only be calculated if the value of the whole enterprise is measured.

Measuring the fair value without direct or indirect reference to a market will be very difficult to perform unambiguously. Of course the values can be estimated, but it is far from certain that the estimated value will equal the market value and, moreover, it is unlikely that the estimate of the fair value can be verified within the margin of acceptable deviation - and thereby be reliable.

Relevance versus reliability

One of the most important areas in the present framework is the balance between relevance and reliability, i.e. the usefulness of information for the investor's economic decisions and predicting the value of the enterprise on the one hand, and assessing the stewardship of management based on the accounting policies that have been applied on the other hand.

If historical cost is applied a measurement will be fairly precise, whereas a prediction of the fair value of the Company will be very difficult to quantify unless a market exists. Valuation models are normally not enough to ensure a proper margin of deviations as these models are based on conditions, which often have a large impact on the estimated fair value, and the value of each condition would be subject to criticism. Uncertainty, and thereby unreliability, in the estimate of fair value will therefore exist, which may lead to fraud due to accounting misstatements in connection with determining management incentives based on the performance of the Company during the financial year.

Necessary conditions for applying fair value

In order to apply fair value as a measurement basis in the financial statement, it is a condition that this can be done with reference to a market that is active or semi-active. If this condition is not met, the theoretical assumptions for applying fair value are not fulfilled (please refer to the above description). When assessing the lowest value, it will be necessary to assess the value in use for the individual Company and in this situation there will always be a significant amount of estimation and thereby uncertainty.

Overall conclusion

We believe that fair value measurement should only be applied in connection with applying the lowest value or with reference to an active or semi-active market. In this respect it should be noted that fair value is not an absolute value like for example a quote of the share price of a listed Company on the stock exchange is for a marginal trade, which is why the price of the share would be different in connection with larger bids on the share. The present market price is therefore not always the fair value of an asset or a liability.

In our view, based on the reasons described above and the detailed answers in the appendix, it is inappropriate to continue with the project regarding "Measurement Bases for Financial Accounting – Measurement on Initial Recognition" at present.

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If you would like further clarification of the points raised in this letter, we would be happy to discuss these in more detail with you.

Yours sincerely

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Chairman of the Accounting
Standards Committee

Ole Steen Jørgensen
Head of Department, FSR
Secretary to the Accounting
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Appendix

This appendix contains our detailed comments on the discussion paper. The paragraph number references are to the full version of the discussion paper, unless stated otherwise.

As mentioned on page 1 we do have several reservations regarding the statements and conclusions in the discussion paper, and therefore we have chosen - at this early stage of the project - to only give more overall comments regarding the questions in the discussion paper.

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 with the identified measurement bases; however it is our opinion that the list should be limited to bases, which have relevance for measurement at initial recognition.

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

We agree with the definition of the measurement bases, but do not agree with the supporting argumentation due to the fact that market value is not an unambiguous term as it is not clear, how "market" should be defined. We would like a more comprehensive definition of markets and a description of which market should be used by an entity.

Moreover, we do see several problems in connection with applying fair value as complete, efficient markets do not exist and information asymmetry does exist. Furthermore, fair value at initial recognition is not linked with the subsequent measurement, which is a severe "missing link" in the discussion paper. At initial recognition we prefer historical cost as this gives a better basis for decision usefulness regarding stewardship, which is a significant element of the purposes of financial statements.

Please also refer to the description on pages 1-3.

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 that management should be measured against the market regarding stewardship and that market value should be applied, if observable market prices for an asset or liability with the same function exist. If a market price does not exist for an identical asset or liability with the same function/purpose, an estimate of the market value without taking the management intent into consideration (entity-specific objectives) would be very difficult. As a market price often does not exist (for example for specialized assets) due to imperfect markets, entity measures will be more relevant with regard to decision usefulness and assessment of stewardship of management.

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)**

Questions A) and B)

The term "market" is not defined clearly enough in the discussion paper, i.e. which market should be applied in connection with the measurement.

It is stated in paragraph number 241 that *".... an asset must have some significant period of exposure to the open market, or that there would need to be significant information dissemination, education and marketing to inform potential participant about the asset or liability, for a market in it to exist"*. Moreover, the condition in paragraph number 107 regarding definition of "markets" states that "*sufficient extensive exchange transactions"* should have occurred. It is our opinion that the essence of the definition of knowledgeable parties is that the parties are always updated on the price of transactions in the market. According to IAS 36 an active market is defined as

"An active market is a market in which all the following conditions exist:

1. *the items traded within the market are homogeneous;*
2. *willing buyers and sellers can normally be found at any time; and*
3. *prices are available to the public."*

If the market for a particular asset is not an active market according to the above definition, published price quotations may have to be adjusted or modified to arrive at a more suitable measure of fair value. For example, quoted market prices may not be indicative of fair value if there is infrequent activity in the market, if the market is not well established, or if small volumes of units are traded relative to the aggregate number of trading units in existence. Accordingly, such market prices may have to be adjusted or modified. Alternative sources of market information may be needed to make such adjustments or modifications according to ISA 545.

Question C)

If a market price does not exist for an identical asset or liability with the same function/purpose an estimate of the market value without taking the management intent into consideration (entity specific objectives) would be very difficult and would make it easier for management to perform earnings management. Furthermore an estimate based on entity-specific objectives is easier to verify, and thereby gives more reliability.

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.

We agree with the definition of entity-specific measurement objectives as stated in the discussion paper. However we do not agree that market values excluding entity specific objectives are more useful for decisions than clean market values, due to the fact the markets are incomplete, inefficient and information asymmetry exists, which is also shown in the example described in paragraphs number 114 and 116.

Moreover it seems that the authors have not taken into account that it is also an assumption that management reacts rationally and makes rational decisions, which together with the lack of fulfilment of the assumptions regarding complete, efficient and no information asymmetry makes entity-specific measurement at initial recognition superior to market-specific measurement objectives.

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.

As mentioned in our answer to questions 5 and our general comments on page 1 we do not support the essential assumptions regarding the market, which seems critical in regards to reaching the conclusion regarding the superiority of market-specific measurement objectives to entity-specific measurement objectives. Therefore we do not agree that market value measurement objectives should be used at initial recognition.

Moreover it is our opinion that management has to be accountable for both its own expectations and for market objectives. When using market value measurement objectives management will only be able to be held accountable in relation to the market but not to its own expectations, which reduces the possibility for assessing the stewardship of management.

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:**

   1 **differences between the value-affecting properties of assets or liabilities traded in different markets, or**

   2 **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.

Question A)

We agree that in theory there is only one market value. In practice the market value will, however, vary from region to region and from deal to deal due to incomplete markets and information asymmetry.

Question B)

In paragraphs 135 through 137 the authors try to explain the weaknesses in the discussion paper's assumption regarding complete, efficient markets and no information asymmetry. These differences are, however, natural due to the lack of fulfilment of the assumptions in the real markets. Please see page 1 for further information.

Moreover the paper several times mentions that the assumptions are not fulfilled such as in paragraph number 136.

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 are unsure of the relevance of the Company's own credit risk associated with a promise to pay in connection with initial recognition. Taking into account the assumptions in the discussion paper regarding complete, efficient markets and no information asymmetry, it is our belief that the market would have included the credit risk in valuation of the debt. It is our opinion that the relevance and impact of the assumptions on the quality of the financial statements including own credit risk in fair value assessment is not clear described. We are therefore of the opinion that the question should be included in the fair value measurement debate in connection with the fair value hierarchy project.

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 paragraphs149-154 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.

Questions A) and B)

The unit of accounts to be applied in connection with applying recognition and measurement principles in IFRS is a very central issue that is not described clearly enough in the discussion paper. The reason is that the discussion paper has not clearly identified the purpose of the financial statements with respect to decision usefulness and stewardship. Moreover the discussion paper does not clearly describe the link between unit of account and market measurement objectives.

Based on the purpose of the financial statement as stated on pages 1-3 it is our opinion that the unit of account should be the lowest possible level of unbundled unit in the specific deal, unless each item is linked and can only be understood as one transaction.

Moreover the unit of account applied at initial recognition should also be made in such a way that subsequent measurement and partial derecognizing can be performed.

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.

It is our opinion that further investigation and description is needed on this part of the discussion paper as the assumptions applied are not fulfilled as mentioned in the answers to the previous questions and in the introduction on pages 1-3. We therefore think that the suggestions proposed in the discussion paper in relation to markets and *"Entry and Exit Markets and Related Issues"*, paragraphs number 162 through 182, are not valid and that management intention should be included in connection with measurement at initial recognition as management has hidden knowledge and the strategy of the Company may differ from that of the Market.

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

We agree that transaction costs should not be included in connection with measurement of fair value; however, with regard to initial recognition the accounting treatment of transaction costs should also be linked to the subsequent measurement

We have already made clear that we do not support the present conclusion made by the authors and therefore suggest that a more comprehensive analysis and description of the framework and measurement is prepared. Please refer to pages 1-3.

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 89of 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 view the discussion paper does not put even emphasis on relevance and reliability nor does it clearly identify the purpose of the financial statements as stated in IASB's present framework. We do not believe that conclusions regarding the measurement bases or priority of relevance versus reliability can be applied based on the isolated discussion that is made in the discussion paper. We therefore believe that the measurement bases at initial recognition should be included in a comprehensive global debate in connection with the fair value projects under FASB and IASB as suggested by the European Financial Reporting Advisory Group in the letter to IASB dated 23 February 2006.

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 generally agree with these paragraphs of the discussion paper; however we believe that the term "sufficient reliability" should be made operational, which would lead to a broader acceptance of the assessment of "sufficient reliability".

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 with the conclusion reached in the discussion paper regarding application of fair value at initial recognition. Moreover we do not believe that the authors have based their conclusion on the right assumptions as it seems that assumptions of complete, efficient markets and no information asymmetry have been applied. Please refer to our answers of the other questions and the introduction on pages 1-3.

As mentioned previously we believe that the relevance of the different measurement bases should be analysed further and linked to subsequent measurement and the purpose of financial statements before a final conclusion can be made.

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)?**

Question A)

We do not agree that a single transaction exchange price cannot be equal to the fair value of the asset or liability, unless there is a clear indication that the exchange price is not the fair value of the asset or liability.

Question B)

We do not agree that a measurement model or technique that is based on entity-specific expectations cannot be the basis for assessing the market value unless there is a clear indication that the expectations are unrealistic. As mentioned in the answer to question 3, if a market price does not exist for an identical asset or liability with the same function/purpose an estimate of the market value without taking the management intent into consideration (entity specific objectives) would be very difficult. As a market price often will not exist (for example for specialized assets) due to imperfect markets, entity-specific measures will be more relevant with respect to decision usefulness and assessment of stewardship of management. We therefore believe that entity-specific objectives should be included due to the fact that existing markets are often not complete or efficient and information asymmetry exists.

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.**

As described both in the introduction pages 1-3 and the answers to questions 1 through 15 we have many reservations regarding the application of fair value at initial recognition as described in the discussion paper. Moreover, we have difficulties in understanding how the conclusion can be reached based on the arguments and statements stated in the discussion paper. The statements and the analysis are based on assumptions that to a large extent do not apply to existing markets.

It is our opinion that the strengths of historical cost in connection with initial recognition of non-financial assets and liabilities are understated compared to the existing market conditions. We believe that the potential weakness using historical cost at initial recognition described in the discussion paper is compensated by subsequent measurement, and therefore historical cost is a good surrogate for fair value at initial recognition as a rational management would not pay more than the net present value for future cash flows connected with the asset or liability.

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 described above we do not agree that fair value is the best measurement basis at initial recognition and believe that the strength of historical cost is understated.

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

We are not convinced that fair value is the best measurement basis at initial recognition and believe that the analysis should be extended to cover the link to subsequent measurement and a more detailed discussion regarding the purpose of the financial statement.

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 believe that this project should not be continued before finalization of the following current projects:

Framework

Phase A of the joint conceptual framework project deals with the objectives and qualitative characteristics of financial reports; an exposure draft is expected shortly. Phase B of the project deals with the elements of financial statements, recognition and measurement attributes; a consultative document is not expected until the second quarter of 2007. The outcome of these phases of the project will provide critical input for phase C of the project, which deals with initial and subsequent measurement. With respect to phase C, the Boards have not yet published an expected timetable.

The Discussion Paper states in the introduction that part of the purpose of the discussion paper is to provide the IASB and national standard setters with "a sound conceptual basis for: (a) revising and expanding the measurement aspects of their conceptual frameworks…" We believe that this purpose cannot be fulfilled without making assumptions about the outcome of phases A and B of the conceptual framework project. It therefore appears to us that the Discussion Paper does pre-empt the outcome of phases in the joint project regarding the conceptual framework, by assuming implicitly that in many cases fair value is the most appropriate measurement model upon initial recognition.

In our opinion any further discussion should therefore await the outcome of phases A and B of the joint conceptual framework project, which will provide direction for the subsequent phase of the project on measurement.

Fair value measurement

FASB is currently developing further guidance regarding fair value to address the concerns that users and preparers have regarding the application of fair value.

The stated near-term objective of the project is to develop a Statement that will establish a framework for fair value measurements, providing a single reference source for fair value measurements required under other accounting pronouncements (Fair Value Statement).

Furthermore the longer-term objective is to improve the conceptual guidance for accounting measurements in FASB Concepts Statement No. 5, Recognition and Measurement in Financial Statements of Business Enterprises, especially in the area of measurement reliability.

As part of the convergent project IASB has also in March 2006 added a Fair value measurement project, which we think should replace the current discussion paper regarding "Measurement Bases for Financial Accounting – Measurement on Initial Recognition".