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Ref: Measurement on Initial Recognition – IASB Discussion paper

ACTEO, AFEP & MEDEF welcome the opportunity to comment on the discussion paper « Measurement bases for financial reporting – Measurement upon initial recognition ».

The issuance of this discussion paper has been expected to open the debate on fair value measurement. Acteo and other numerous European and non-European stakeholders have been requesting for some years now that debate on measurement take place before more fair value measurements would be potentially introduced into IFRS.

In such a context, the discussion paper is source of heavy disappointment. It indeed fails to truly open the long awaited debate:

A- There is no argument supporting the asserted superiority of market value objectives

Although relevant conceptual extracts have been selected in Chapter 2 (stewardship objective assigned to financial information (DP.11), predictive value (DP.13), economic purposes and their embodiment in assets and liabilities (DP.19-20), these extracts are not referred to in order to justify the conclusion reached at the end of Chapter 4, that market measurement objective is superior to entity-specific objectives. Chapter 4 is limited to the parallel description of market-value and entity-specific objectives, as they are likely to support financial reporting objectives. No comparison is made in terms of decision usefulness or predictive value. As a result, the conclusion reached fails to be supported by valid reasoning and arguments. For example, it is still very unclear to us why:

- reflecting management's, assumptions, expectations would lead to financial information lacking predictive value, although management develops talents and energy to make its expectations happen with the objective of maximising shareholders' value,
- reflecting management's perceptions of the entity's advantages and disadvantages would result in less relevant financial information, although it is likely to bring information closer to cash outcomes expected in reality,
- justifying accounting measurement requirements on the basis of pure financial theory would lead to more relevant financial information, when there is absolutely no perfect market, when the underlying economics that financial information purports to portray are known to originate from markets which are truly inefficient.

The paper contains neither convincing, nor non-convincing arguments, that market objectives are superior. Without proper analysis of why it would be so, there is no basis for starting a debate on what benefits fair value could eventually bring to financial reporting. Unfortunately another discussion paper phase is needed before the IASB can hope to convince its constituents that it is heading into the right direction.

B- *There is no discussion of what financial position and performance financial statements ought to reflect*

There is no analysis whatsoever of what financial position and performance financial reporting is supposed to portray. For example, the comparison in chapter 4 of market and entity-specific objectives establishes that the effects of any entity-specific advantages and disadvantages:

- o would "appear as a gain or loss only when they are realized or reflected in market value" if market objectives were followed,
- o are "reflected in the initial measurement of the asset or liability", when entity-specific objectives are followed.

There is no explanation whatsoever of why market objectives are superior, reflecting into company's performance gains and losses arising from the entity's transactions being benchmarked to market at inception.

In our view, no wide understanding can be reached in the debate on fair value without careful insights into what performance financial information should lead to portray. The IASB's logic so far has been the following:

- o *fair value measurements have been required as part of IFRS, without any convincing debate taking place;*
- o *fair value measurements trigger increases or decreases in assets and liabilities;*
- o *in accordance with the framework, every change in asset or liability should be reflected in the entity's performance, leading to ever-changing performance measurements.*

We believe that a valuable debate on measurement should be based on an appropriate analysis and definition of the performance model that changes in value of assets and liabilities should trigger. It should be developed with the objective set in paragraph 19 in mind, i.e. "since it is the cash-equivalent expectations attribute of assets and liabilities that is the primary focus of business activities, it seems appropriate to conclude that this attribute should be the primary focus of accounting measurement".

C- *Acceptable reliability is not defined.*

The paper emphasizes improvements reached in capital market pricing literature and practice, in the application of present value and statistical probability techniques, in measurement practices, and in computer and information technology (par. 23-29).

Later in chapter 6, the paper develops some valuable thinking on reliability. The paper concludes that relevance should prevail on reliability whenever "an acceptable level of reliability" is provided. There is however no attempt at defining what such an acceptable level of reliability ought to be. Instead, it is suggested (par 97-99) that disclosures can adequately cope with any level of uncertainty contained in financial information.

While we broadly agree with the proposal that, provided an acceptable level of reliability is obtained, the most relevant of measurement bases should be selected, we would apply this proposal on the following bases:

- 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 operations.

We believe the measurement debate should adequately develop reliability and relevance concerns. This requires more in-depth insight than provided in the present discussion paper.

D- *The analysis is limited to initial recognition, leaving aside the difficult issues linked to subsequent measurement, i.e. D1 and D2 profit and loss recognition.*

Assessment of measurement bases is being made in light of initial recognition issues only, leaving aside the more complex issues of subsequent accounting, in particular the debate on profit and loss recognition. Consequently, the discussion process leading to conclusions on when and why fair value should be used remain outstanding, pending further study of subsequent accounting.

As acknowledged in the discussion paper, conclusions reached in light of initial recognition only may well be overridden when subsequent measurement is discussed. Therefore, and very unfortunately, no much progress can be expected from the discussion arising on the basis of the present discussion paper.

In conclusion and on the basis of the comments expressed above and in the appendix, we believe the IASB should plan on issuing its own discussion paper, in order to really give a start to the long awaited debate on fair value measurement. We strongly recommend that this second phase be undertaken as soon as possible.

We remain at your disposal should you need further clarification or background information.

Yours sincerely,

ACTEO	*AFEP*	*MEDEF*
Le Président	Le Directeur Général	La Directrice des Affaires Economiques, Financières et Fiscales
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APPENDIX: responses to the questions asked in the paper

Note: all references included below refer to the condensed paper

Question 1*—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.*

The list drafted in the paper seems quite comprehensive. We do not have any supplementary suggestion to make.

Question 2*—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)?*

The terms and definitions included in Chapter 3 of the discussion paper seem to fit what we believe is understood in IFRS literature. However we disagree with the following:

(a) *Historical cost*— We believe historical cost should remain based on the accumulation of costs that can be attributed to the asset. We do not see the contradiction suggested in paragraph 36 that including allocations of cost would undermine the definition "fair value of the consideration given". Allocations schemes belong to the world of estimates and we do not see why they should be considered as arbitrary. They are meant to approximate the costs incurred by the entity and are usually based on some acceptable rationale. We believe they need to be part of the consideration given if costs are not to be underestimated. We also believe that fair value of the consideration given at "the date of acquisition" refers to the accumulation of the fair value of each bit of consideration at the time it is transferred, the accumulation coming to a stop at the time the asset is ready for the intended use.

(b) *Value-in-use*— We support definition of value-in-use fitting the description contained in paragraph 45, i.e. meeting the objective of reflecting the reporting entity management's best estimates of future cash flows, discounted using current market rates. We do not support the direction favored in paragraph 166.

Question 3*—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 main sources identified in chapter 5.

Question 4*—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 believe that the paper has defined reasonably well the market value objective (a) and we can accept the proposed definition of a "market" (b). However we could not find in the paper any indication why these would be suitable for financial measurement purposes. The fact that they are based on finance theory which calls for markets being assumed as fully efficient is not the least convincing, in our view, that the market value objective would be suitable to reflect real life economic substance. In real-life, even the most active markets cannot be assumed to be efficient. We therefore seriously doubt, and there is nothing in the paper for preventing us from such doubt, that pure finance theory can well serve a fair reflection of actual economics. Only arguments explaining how market based measurements best serve the predictive value of financial reporting would have a chance to be convincing. In our view the paper asserts that the market value objective is superior without ever coming close to explaining why it would be so. Developing the missing arguments is essential before any debate on the relevance of fair value can take place. We regret that this paper represents a missed opportunity to open the debate.

Question 5*—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 we do not agree with the definition given. In our view, entity-specific measures are not necessarily based on management's intentions. We also disagree with the so-called "discussion". We do not believe that an argument in favor of entity-specific measures would necessarily lie in management being held responsible for its forecast. We believe management is being held responsible 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 that entity-specific measures are likely to embody in assets and liabilities probable future cash in- and out-flows (which can be based on the entity's capabilities rather than on management's intentions), and therefore contain a high degree of predictive value.

We also believe that reflecting in measurement od assets and liabilities the knowledge that management has of its operations leads to providing to market useful and otherwise unavailable information. Accordingly, we believe that entity-specific measures are more likely than market based values to meet what has been identified in chapter 2.19 as the primary focus of accounting measurement, i.e. "the cash-equivalent attribute" of assets and liabilities.

Question 6*—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 observe that market and entity-specific measurement objectives are described, however only in parallel, without ever being really compared in terms of efficiency in meeting financial reporting objectives. There is therefore no comparison as such with which we could agree. In addition, our disagreement expressed in answering question 5 indicates that we disagree with the description made of entity-specific objectives.

Moreover we note, as already indicated, that there is no argument whatsoever to explain why the qualities identified in market objectives would best serve financial statement predictive value. There is also no indication as to why significant information contained in entity-specific measurements would be best shown as separate forecasts or supplementary disclosures (par 61), rather than being embodied in assets and liabilities. Many stakeholders take the opposite view and state that fair value measures may be best provided as disclosures, when observable prices are available and when fair value measurement does not fit the entity's or the segment's business model.

***Question** 7*

(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 with the conclusion expressed in (a) that pure finance theory based on fully efficient markets would lead to only one fair market value on any measurement date for an asset or liability. We note that the authors acknowledge in the end of paragraph 63 that reality observed in practice is quite different from what is expected from theory. We therefore question further, as we did in our answer to question 4, why market value objectives, justified only by their link to finance theory, have been asserted superior.

We also agree with the observation made in (b)(i) that the so-called value affecting properties do explain differences in market values for seemingly identical items. Units of account and appropriate market sources are in our view to be selected from the perspective of the reporting entity. They are dependent on the entity's business model (trading vs asset-liability management, for example), the choices made by the entity in the conduct of its operations (identification of the lowest level of aggregation at which the asset can generate cash). Relevant measurement attributes can therefore not be selected on the basis – or worse the assumption – of choices made by "any" market participant. We believe acknowledging their influence and significance contradicts market value measurement objectives as proposed in the paper.

Furthermore we question the conclusion reached that transaction costs (taken as an example of "entity-specific" charges or credits) are "not recoverable in the marketplace on the measurement date" (par. 86). According to the existing IFRS literature, those costs are included in the cost of acquisition or added to the fair value of assets upon initial recognition and impairment remains the exception, not the rule. In most operations, a transaction carried out with or without incurring transaction costs, would not be concluded at the same price. Transaction costs can therefore be considered as counter-balancing market inefficiencies. To recognise them separately from the transaction price does not seem relevant. We also observe that active market participants entering similar transactions incur the same nature of costs.

Overall, we agree with most observations made by the authors in that part of the paper, as they indicate how relevant a role the entity's perspective should play. These observations in our view contradict the asserted greater relevance of market value objectives. They also show that finance theory is not applicable to real life economics.

Question 8*—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 believe own credit risk is embedded in the amount incurred in a liability upon initial recognition. The issue addressed by most commentators in respect of own credit risk is linked to subsequent measurement. We among others have already explained why we believed that reflecting variations in the entity's credit risk in the subsequent valuation of its liabilities was not relevant and likely to distort performance. We believe however that this issue is outside the scope of the present discussion, as the authors have chosen to restrict their first thinking to initial recognition.

Question 9*—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.

It is our understanding that one of the main reasons why the authors have chosen to limit their thinking to initial recognition was to avoid – as much as possible – dealing with revenue or profit recognition. We note that only an accumulated costs model eliminates all sorts of D1 profit. Fair value upon initial recognition as proposed in the paper does not.

Answering question 9 cannot be separated in our view from subsequent measurement issues. The answers should be derived from the definition of what financial performance and position are meant to portray, an issue which is not even mentioned in the paper. We believe no measurement debate can take place without defining first what the analysis of gains and losses arising from initial recognition or from changes in value of assets and liabilities is meant to represent.

In our view, this is the second reason why the discussion paper fails to support the opening of a valuable debate on measurement.

Question 10*—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.*

Same answer as to question 9.

Question 11*—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.*

Please refer to our answer to question 7.

Question 12*—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.*

Yes, we broadly agree with the proposal that, provided an acceptable level of reliability is achieved, the most relevant measurement basis should be selected.

However, we would apply this proposal on the following bases:

- 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 operations.

Question 13*—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, in principle.

However the discussion paper does not raise the most critical issue related to reliability, which is to define what "an acceptable level of reliability" means. In our view, such a definition is essential to the measurement debate and there is no attempt in the paper to propose such a definition. Financial statements cannot provide relevant information if the reliability threshold is defined too low, as some suggest it would be done. Please refer to our comments in answer to question 12 above.

In our view, this is the third reason why the discussion paper fails to open the measurement debate.

Question 14*—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.*

No, we do not agree with the conclusion reached that fair value is the most relevant measure of assets and liabilities. As we have explained earlier, we fail to see:

- the rationale supporting the superiority of market value objectives, in an environment where no efficient market exists,
- the relevance of the financial performance and position model embedded in such a choice,
- the conditions in which fair value – or other measurement attributes – would be deemed to meet an acceptable reliability threshold.

In our view, a second discussion paper is needed, developing material appropriate to dealing with the items listed above, to sustain a valuable debate on measurement issues.

Question 15—*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 paragraphs106-114 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 believe the conclusions and supporting arguments in the paper regarding the reliability of fair value have the merit of consistency with the objectives set for market value. We further note that the logic followed by the authors ought to lead to the conclusion that fair value can never be estimated reliably as no efficient market exists, although the authors believe that there would be occurrences in practice when fair value would be determinable.

We note that to reject the presumption that transaction prices have the "quality" of fair value is consistent with the authors' conclusions. This leads us to oppose to these conclusions and in our view further demonstrates that a model based on pure finance theory cannot lead to relevant reporting.

If applied consistently, the model proposed would lead to the recognition of D1 gains and losses, meant to recognize upfront differences between the entity's and market's efficiencies, although differences measured would only feature market inefficiencies. We strongly oppose to such a reporting model.

Question 16—*Do you agree with the paper's analyses and conclusions with respect to the comparative relevance and reliability of:*

- *historical cost (see paragraphs 120-137 of the condensed version and paragraphs 281-319 of the main discussion paper);*
- *current cost - reproduction cost and replacement cost (see paragraphs 138-154 of the condensed version and paragraphs 320-361 of the main discussion paper);*
- *net realizable value (see paragraphs 155-161 of the condensed version and paragraphs 362-375 of the main discussion paper);*
- *value in use (see paragraphs 162-169 of the condensed version and paragraphs 376-392 of the main discussion paper); and*
- *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 believe the entire analysis contained in this part of the paper is biased and therefore not deserving a detailed commentary. In particular, we believe the relative weaknesses of historical cost and strengths of fair value have been overestimated. However, even if this analysis had been conducted in a more neutral fashion, we believe we would have disagreed with its conclusions:

- on the basis of the views we have expressed in answering to questions 4 to 6,

- in the absence of the main discussions still to take place (please refer to our answer to question 14).

Question 17*—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.*

In the absence of any rationale for asserting the superiority of market value attributes, we disagree.

Question 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 disagree for the reasons given all through our answers to the above questions.