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Discussion Paper *Measurement Bases for Financial Reporting – Measurement on Initial Recognition*

Dear Director, Accounting Standards:

UBS is pleased to have the opportunity to provide comments on the IASB-issued Discussion Paper, *Measurement Bases for Financial Reporting—Measurement on Initial Recognition* (the Paper) prepared by the staff of the Canadian Accounting Standards Board. We have reviewed both the condensed and long-form versions of the Paper. We fully support the IASB's initiative to carry out such a preliminary investigation of accounting measurement bases on initial recognition; however, we have fundamental concerns on some of the principles and conclusions reached by the Paper. This comment letter provides high level comments on the proposals, focusing on those areas that will require further investigation and discussion. This letter also provides responses to selected discussion questions in the Paper.

General comments

Scope of the Paper

The Paper analyzes several bases of measurement for assets and liabilities on initial recognition; however, the Paper does not address when initial recognition should occur (though the Paper does propose that initial measurement should be determined as of the date of initial recognition). We urge the Board to consider that issue in connection with initial recognition. For instance, accounting based on historical costs typically deals with measurement uncertainty by deferring initial measurement until such uncertainties are resolved. Those methods of dealing with measurement uncertainty may not be appropriate under fair value (FV) measurement because uncertainty enters directly into the determination of fair value. Thus, it may be necessary to recognize an asset or liability earlier than when using non-fair-value measurement bases. Therefore, determining when an asset or a liability should be recognized should form an essential part of the discussion on initial measurement.

In addition, the Paper does not address subsequent measurement (or remeasurement) issues, including impairment. The Paper suggests that remeasurement will be dealt with in subsequent papers. We believe that the discussion of initial measurement should be performed in conjunction with remeasurement for the following reasons:

- Firstly, the combination of initial and subsequent measurement determines how changes in assets and liabilities will be recognized throughout their respective lives – the timing and amount of those changes will give rise to income and expense.

- Secondly, we understand that measurement is a complex topic; however, breaking it up into initial and subsequent measurement may not be the best approach to analyzing this topic. For instance, conclusions reached on initial measurement may not hold in the face of conclusions reached on subsequent measurement. We think it would be better for Board members to keep an open mind and consider initial and subsequent measurement as an integrated whole.

Specific comments

Market measurement objective and market value

The Paper proposes that there should be, in theory, only one market (fair) value for an item on any measurement date. The Paper suggests that this value is determined by reference to the market in which the entity acquires the asset or incurs the liability.

Market inefficiencies exist in any market and, therefore, impact observable market prices. The Paper gives examples on how to determine the appropriate fair value. The Paper also discusses large blocks and volume effects, concluding that the effect of creating a large block as a result of a number of purchases of smaller blocks is a matter for remeasurement. We believe that it is extremely important that clear guidance be provided in respect of how to determine the "Only" one market (fair) price. The Paper proposes that an in-depth study of markets with apparently different prices for identical assets or liabilities be performed to assess the nature and causes of those price differences. We believe that efforts expended to provide a better and more comprehensive understanding of markets and their impact on fair value are beneficial. Further, we believe that the scope of any further investigation should be expanded to include subsequent measurement.

The Paper concludes that the market value measurement objective would reflect the price for an asset or a liability that would result from a competitive market and, therefore, the market measurement objective is superior to an entity-specific measurement objective. This may not always hold, especially in the absence of observable market prices. We believe the Board should perform further research that involves users of financial statements to determine what type of measurement provides the most decision useful information when no observable market exists for a particular asset, liability, or combination thereof.

Transaction price

The Paper concludes that a transaction price should not be described as fair value on initial recognition unless there is persuasive evidence that it does have the essential properties of market value. However, when fair value cannot be estimated reliably, measurements based on entity-specific measurements or transaction prices may provide the most relevant measure. The Paper suggests that the difference between the transaction price and fair value, if it could be reliably measured at initial recognition, would be recognized as a gain or loss. The Paper also implies that on initial recognition, persuasive evidence will be required to demonstrate that fair value equals transaction price, otherwise, the transaction price will be referred to as historical cost. The FASB's near-final draft of a Statement on Fair Value Measurement notes that in many cases the transaction price will represent fair value at initial recognition but not presumptively. That draft explains that the transaction price and the fair value are conceptually different. We believe that the Board should consider that type of approach, providing guidelines for determining when the transaction price and fair value are similar or different. Additionally, we would suggest that the Board provide examples to illustrate the application of those guidelines. We also would remind the Board to consider the recommendation specific to market valuation methods (i.e., recommendation three) in the Special Report on Global Derivatives—Derivatives: Practices and Principles, issued by the Group of Thirty in July 1993. It is very important that a converged position be achieved with respect to views on the transaction price and fair value.

Unit of account

The Paper explains that a portfolio of assets or liabilities could have a fair value that differs from the sum of the fair value of individual assets or liabilities making it up. The Paper proposes that the appropriate individual item or portfolio unit of account on initial recognition is generally the unit of account in which the reporting entity acquires an asset or incurs a liability. Though we support the notion that, in concept, the unit of account on initial recognition is either an individual item or a group of assets depending on how the entity acquires the asset, we believe that the unit-of-account discussion would only be meaningful when subsequent measurement is taken into account. In addition, we also would observe that the market may differ depending on the selected unit of account.

For non-contractual assets, the Paper proposes that the appropriate level of aggregation 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. The Paper suggests that any synergistic effects of the aggregate of inputs into an asset to make it ready to contribute would be reflected in its fair value on initial recognition. We do not support the conclusion on the unit of account for non-contractual assets on initial recognition. We have concerns related to the recognition of a gain or loss on initial recognition because of the synergistic effects of aggregating inputs into an asset. Specifically, we question whether such accounting provides the most decision-useful information to financial statement users.

Transaction costs

The Paper proposes that transaction costs, if not recoverable, are not part of the fair value of the asset or liability. We do not support that recoverability is the basis to determine whether transaction costs should be included in determining fair value. We believe that transaction costs should be included in determining the fair value on initial recognition if they relate to an attributable part of the particular asset or liability, especially for non-contractual assets. For instance, when entities transform inputs into products for sale or transform inputs into other assets for internal use (e.g., a building), transactions costs become an attributable part of the asset. We would suggest that recoverability be considered in subsequent measurement.

FV Measurement Hierarchy

The Paper's proposed hierarchy is different from the FASB's near-final draft of a Statement on Fair Value Measurement that distinguishes the levels between inputs to valuation techniques used to estimate fair value. Under that draft, all three levels currently proposed (including those applying to models and techniques that use entity-specific inputs only) are considered as fair value. We reiterate that it is very important that any proposal on fair value measurement should be aimed to achieve the IASB's long term objective to converge with US GAAP.

Our responses to selected questions are attached as an appendix. If you would like to discuss any comments that we have made, please do not hesitate to contact Ralph Odermatt at +41 44 236-8410 or John Gallagher at +1 203-719-4212.

Regards,

UBS AG

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cc:
Wayne Upton, Director of Research, IASB
Kevin McBeth, Project Manager, FASB

Appendix - Responses to Selected Discussion Questions

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 Paper explains that the market measurement objective is implied by the definition of *fair value*, yet notes that the term *market* is not found in the definition. While we do not support changing the term *fair value,* we think that excluding key principles from definitions is not consistent with "plain" English, adds to the complexity of accounting by requiring the Board to provide additional commentary on the meaning and interpretation of key terms, and has a tendency to cause misinterpretation because of the two aforementioned points. If the market measurement objective is a fundamental principle of fair value, then it should be made explicitly clear in the definition.

On a different note, we are concerned about the interaction of this Paper and the FASB's project on fair value, in which fair value is determined to be an exit price. There must be a common, converged definition and understanding of the term *fair value.*

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)?**

Our comments on this question relate to part (b) and the proposed definition of *market.* The paper has proposed the following definition:

> *A body of knowledgeable, willing, arm's length parties carrying out sufficiently extensive exchange transactions in an asset or liability to achieve its equilibrium price, reflecting the*

> *market expectation of earning or paying the market rate of return for commensurate risk on the measurement date.*

In our capacity as a global financial services firm, we make markets and act as a "knowledgeable, willing, arm's length party" in numerous transactions every day. We have some concerns about the proposed definition and some of the related topics addressed in the Paper.

The Paper's discussion of the efficient market hypothesis and its attributes leads to the conclusion that the meaning of the proposed definition of *market* is a "perfect" market. How many perfect markets exist? Economists continue to study this very notion and new theories, such as behavioral economics, question whether entities act rationally at all times. Furthermore, if markets are not perfect, then observable market prices from active markets can only provide evidence of what the fair value may be; indeed, it would be virtually impossible to verify fair value.

The proposed definition raises a number of questions. How big is a *body*? What is the meaning of *sufficiently extensive*? What is the *equilibrium price*? In paragraph 239, the Paper notes that "the definition of *market* proposed above would require some significant supporting guidance to enable reasonable and consistent judgments to be made." We agree with that statement. The Board and its constituents would benefit from additional study on the meanings of those terms. In addition, the Board should consider the effect of market anomalies (for instance, when trading is halted temporarily on an equity security) in the context of the proposed definition. Given our discussion in the preceding paragraph, it seems clear that a relaxed definition of market (that takes into account market imperfections) is more operational than the proposed definition.

Of greater concern is the market measurement objective when there is no market that meets the proposed definition (putting aside the perfect market). There are some financial assets and liabilities and many nonfinancial assets and liabilities for which no market meeting the proposed definition exists. We do not believe that this paper adequately addresses those types of situations. This paper does not appropriately discuss the absence of a market with the discussion of entity-specific measurements. We would hope that some time can be spent by the Board in its conceptual framework project on that particular issue. Furthermore, if no market meeting the proposed definition exists, is there another measurement objective, rather than the market measurement objective, that becomes central in making measurement decisions? More research should be performed in this area.

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.

The Paper fails to discuss entity-specific measurement objectives and their relationship to management intentions when there is no market meeting the proposed definition for an asset or a liability. We believe this issue deserves further consideration, especially in light of the overall financial reporting objective of providing users of financial statements with decision-useful information. We believe that such consideration should involve users of financial statements. We are not sure if the arguments summarized in paragraphs 118 and 119 are from users of financial statements or accountants. Heavier weight should be given to the views of users.

The Paper asks the following question:

> In particular, should asset and liability measurement on initial recognition reflect an entity's expected advantages or disadvantages that are not factored into market prices, or should measurement reflect the market's expectations? (paragraph 115)

You cite Concepts Statement 7 to support the assertion inherent in that question. However, Concepts Statement 7 also notes the following:

> An observed market price encompasses the consensus view of all marketplace participants about an asset or liability's utility, future cash flows, the uncertainties surrounding those cash flows, and the amount that marketplace participants demand for bearing those uncertainties.

In deciding to purchase an asset or group of assets, management will take into account the economic attributes discussed in paragraph 23 of Concepts Statement 7 and they will use entity-specific assumptions. In purchasing the asset or group of assets, the buyer becomes a marketplace participant whose view becomes embedded in the price of an asset. In addition, if the buyer buys more assets because they are relatively inexpensive, this demand will likely increase the price over time. The main point of this discussion is that entity-specific assumptions are subsumed into market prices. We believe that this point is fundamentally important and that the Paper's assertion that market prices do not incorporate such views is inaccurate.

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.

This table makes an important assumption: that reliable measures can be obtained for both fair value and entity-specific value (see paragraph 126 of the Paper). This section relies on that assumption in order to draw its conclusion that fair value is a more relevant measure than entity-specific value. We strongly support fair value measurements for many types of financial assets and liabilities on initial recognition. However, in the absence of a market or market-based measurement techniques, the key assumption underlying the table does not hold. As noted previously, we believe that more research should be performed on whether another measurement objective provides more relevant information to users of financial statements in those situations.

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 would like to reemphasize that work on the meaning of fair value must be performed with the FASB to achieve a converged position. We understand the economic theory behind the law of one price. However, we are concerned that the Paper oversimplifies the discussion of entry and exit markets, especially for enterprises that operate in each of them (for instance, the retailer of nails discussed in the paper). Suppose a customer purchases a new automobile from a dealer for €25,000 and the dealer pays a commission to its salesperson of €1,000 upon completion of the sale. Is the fair value of the automobile for both the dealer and customer €24,000? Is the commission a transaction cost? If the customer takes delivery of the automobile (without having driven it), it is now used and might be sold for only €23,000 by the customer. Perhaps, that change is due to a change in a value-affecting attribute. However, it is not clear whether the customer should recognize the asset at €25,000; €24,000; or €23,000. Such questions are too important not to address. We urge the Board and its staff to deal with several detailed, real-world economic phenomena in discussing how market access charges, transaction costs, and entry/exit markets affect fair value when there are markets and when there are no markets for the asset or liability in question.

We also would remind the Board to consider the recommendation specific to market valuation methods (i.e., recommendation three) in the Special Report on Global Derivatives—Derivatives: Practices and Principles, issued by the Group of Thirty in July 1993. The recommendations contained in that report have been broadly implemented in our industry and would provide the Board with further insight on the pricing and valuation of financial instruments.

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.

In response to Part (a) of this question, please refer to our response in Q7. As to Part (b), we find this objective to be vague and ambiguous. For instance, if an entity builds its own building and the construction occurs over one year, should there be no recognition until it is completely finished? A literal reading of this objective would suggest that no identifiable asset exists until the building is completed (at which time it would be measured at fair value). This objective ignores the value associated with a partially constructed asset. Or, perhaps, this objective really goes to subsequent measurement?

We return to the building example for a moment. Suppose a building is constructed for $100 million and the fair value of the building upon completion is $200 million (because the value of commercial real estate has risen sharply during the period of construction). What information would users of the financial statements find more valuable? Should the asset be initially recognized at $200 million and depreciated over the service life, running the risk that a decrease in the commercial real estate market may cause an impairment in a few years time? Perhaps, the decision to use fair value recognition in this case should be optional or intent-based, like IAS 39's fair value option or intent-based method for the classification of investment securities? Perhaps, users of financial statement would prefer to see the $200 million simply disclosed in the footnotes to the financial statements? A fair value measurement option or disclosure may be highly relevant to users of financial statements. Again, we believe that the Board should seek to obtain more information from users of financial statements in determining the answers to such questions.

We have used the example above to demonstrate that additional detailed examples should be used in explaining and illustrating objectives. Without such examples, it can be difficult to provide comments that are helpful to the Board in achieving its objectives.

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.

We think that the Paper needs to further address those issues. We appreciate that the Paper discusses demand deposits, which is an important topic for us. Paragraph 173 and footnote 62 present the rationale for reporting demand deposits at less than their face amount when they are initially recognized. Footnote 62 notes that "this circumstance arises in part because this exit value takes into account the expectations of buyers and sellers that a significant percentage of demand deposits will be left on deposit for an extended period, during which they will bear a lower rate of interest than would be borne by term deposits over the same term." We support the validity of this argument; however, the Paper favors the "one" fair value notion and concludes that other factors must explain the apparent difference between the entry and exit values. We believe that conclusion is invalid as it is based on the key assertion that entry and exit values cannot be different because there is only "one" fair value. Paragraph 173's discussion on demand deposits provides an example of why that key assertion may not hold. As noted previously, the FASB's near-final draft Statement on Fair Value Measurements explains that transaction prices (entry values) and exit values are conceptually different. As noted in our response to Q7, we believe that the Board must clearly explain the difference between entry and exit values as well as transaction costs and market access charges for a variety of real-world economic phenomena. We believe that such an explanation, supported by examples, will be the only way to verify the integrity and completeness of any measurement model for financial reporting.

On a related matter, Paragraph 173's discussion of the rationale for reporting demand deposits at less than their face amount when they are initially recognized fails to note the economic validity of such an argument; rather, it appears to cast doubt on the argument's validity (as noted in the preceding paragraph) without sufficient justification. We would add that taking into account the behavior of depositors in estimating fair value is no different than taking into account the early exercise behavior of employees in determining the valuation of an option-based compensation award or taking into account the prepayment behavior in the valuation of mortgage-backed securities. Valuation techniques for taking into account that type of behavior are well-proven under economic theory and generally accepted by valuation experts.

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.

This section does not address whether the existence of a market for the asset or liability changes the conclusion. In fact, it states that for entity-specific measures transaction costs may become part of the asset or liability's value. Previously, we have stated that, perhaps, there is another measurement objective that should be used when markets or market-based valuation techniques do not exist. In line with that observation, it may be that transaction costs should be a part of an asset or liability's value, as suggested by the Paper.

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.

As noted in Q6, we strongly support the use of fair value for most financial assets and liabilities on initial recognition. However, it is not clear that fair value is the most relevant measure for nonfinancial assets and liabilities. We believe that more work with users of financial statements should be performed in this area. Recently, the FASB created an Investor Task Force to obtain user feedback on whether accounting treatments and disclosures are decision useful. We would recommend that the IASB create a similar group to help it explore such measurement issues.

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.

Once again, we believe that the FASB and the IASB must achieve a converged position on this issue.