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Mr Peter Martin
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Dear Peter

Discussion Paper: *Measurement Bases for Financial Accounting – Measurement on Initial Recognition*

CPA Australia appreciates the opportunity to comment on the Discussion Paper: *Measurement Bases for Financial Accounting – Measurement on Initial Recognition*. Our comments have been prepared in consultation with members through our Asia-Pacific Financial Reporting Advisory Group (APFRAG) which is a Board Committee representing a regional perspective from South-East Asia, Oceania and Australasia and our Financial Reporting and Governance Centre of Excellence.

Overall, CPA Australia agrees that fair value is the normatively appropriate measurement basis for assets and liabilities on initial recognition. However, our members contend that the discussion paper and its conclusions would be more robust and improved from a better discussion of the application of fair value in:

- stock markets that are not deep and active (e.g., stock markets other than the major markets, given it seems plausible that in the major stock markets a rational consensus will be reached as to the share prices which best reflect the prospects of future cash flows given available information[at least for actively traded shares]); and
- markets for assets other than stock or foreign exchange markets (e.g., markets for different intangible assets).

A focus on subsequent measurement would have also been helpful to commentators to enable them better to consider the relevance of fair value on initial recognition.

CPA Australia is concerned that the International Accounting Standards Board's (IASB) process for the development of this discussion paper is not the most robust method for achieving the objective of developing a single set of high quality, understandable and enforceable global accounting standards. We accept the leadership role to be played by national standard setters in research projects, however, we have reservations that this project has progressed without the benefit of deliberations by the IASB. We consider this a weakness of the research project model utilised. We note the discussion paper proposes a measurement hierarchy for assets and liabilities on initial recognition not consistent with the fair value hierarchy expected to be articulated in the Financial Accounting Standards Board (FASB) standard on fair value measurement.

CPA Australia has difficulty in rationalising this inconsistency, given the IASB's objective of ensuring consistency in approach with FASB re the fair value measurement objective in accounting for business combinations (and the first step to achieving this objective is to expose for comment the FASB exposure draft fair value hierarchy and related guidance as the IASB's guidance on measuring the fair value of an acquiree's assets and liabilities in accounting for a business combination). CPA Australia would have preferred a process whereby the staff of the Canadian Accounting Standards Board (AcSB) were able to progress the project with the benefit of deliberation of the IASB and FASB. We recommend that the practice of "benefiting from the deliberations of the IASB (and other standards setters when relevant)" be required of future projects.

Our detailed comments are attached to this letter.

Should you have any queries on our comments, please contact Dr Mark Shying our Financial Reporting and Governance Senior Policy Adviser on email: mark.shying@cpaaustralia.com.au.

Yours sincerely

Geoff Rankin FCPA
Chief Executive Officer

cc: D Boymal
D Tweedie
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Discussion Paper: *Measurement Bases for Financial Accounting – Measurement on Initial Recognition*

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.

CPA Australia agrees that the list of possible measurement bases discussed is comprehensive.

Our members agree with the proposition that there "…seem[s] to be acceptance among accounting standard setters that the objective of fair value measurement is to represent the market value of an asset or liability at the measurement date" (paragraph 92). They contend that the discussion paper and its conclusions would be more robust and improved from a better discussion of the application of fair value in:

- stock markets that are not deep and active (e.g., stock markets other than the major markets, given it seems plausible that in the major stock markets a rational consensus will be reached as to the share prices which best reflect the prospects of future cash flows given available information[at least for actively traded shares]); and
- markets for assets other than stock or foreign exchange markets (e.g., markets for different intangible assets)

rather than the academic style discussion of the theories presented in the discussion paper.

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)?

Overall, nothing has come to our attention to suggest that the working terms and supporting interpretations as discussed in this paper are not appropriate.

However, our members contend that satisfying the objective of developing a single set of high quality, understandable and enforceable globally accepted financial reporting standards requires the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) to agree a consistent definition and notion of fair value. We understand that as part of the IASB's Business Combinations Phase II project, the definition of fair value will be consistent with that developed by FASB. Our view is that the Canadian Accounting Standards Board (AcSB) staff should have prepared this discussion paper in consultation with both the IASB and FASB staff to ensure a consistent approach. This issue is compounded by the expectation that the IASB will be issuing the Draft FASB Statement as an exposure draft in the first half of 2006.

Moreover, the definition of historical cost should refer to the construction of assets as well as their acquisition.

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.

Nothing has come to our attention that would suggest that the sources of differences identified for measuring assets and liabilities on initial recognition would not be other than the two sources identified.

CPA Australia understands asset prices in an efficient market to reflect information up to the point where the marginal benefits of acting on the information do not exceed the marginal costs of collecting it (as opposed to the asset prices reflecting market participants' collective assessment of all information available in the marketplace at the time). We agree that not many markets are fully efficient, for example:

- stock markets that are not deep and active (e.g., stock markets other than the major markets, given it seems plausible that in the major stock markets a rational consensus will be reached as to the share prices which best reflect the prospects of future cash flows given available information[at least for actively traded shares]); and
- markets for assets other than stock or foreign exchange markets (e.g., markets for different intangible assets).

However, we are concerned that the conceptual analysis has not adequately examined the relevance of the market value measurement objective to markets of the type identified above. Accordingly, we are concerned that the rejection of the entity-specific measurement objective is a consequence of the narrow analysis of the market value measurement objective. We are not convinced that the discussion paper demonstrates that all relevant information is necessarily better conveyed by market measures (as opposed to entity-specific measurement objectives).

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)?

Nothing has come to our attention to suggest that the objectives, properties or definitions of the market value measurement objective are inappropriate. We understand, however, that there is an implicit assumption that markets are always efficient (but see our comments at question 3 above). As such, we would suggest that the AcSB consider the practical implication of this assumption and the potential for the over reliance on estimation models to proxy fair value.

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.

Nothing has come to our attention to suggest that the definition and discussion of entity-specific measurement objectives are inappropriate.

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 accept that theoretically, the market value measurement objective as described in this discussion paper has important qualities that make it more relevant than entity specific measurement objectives. However, this is under the assumption that markets are efficient.

We note that paragraph 128 states that the "market value measurement objective….[is] superior to an entity-specific measurement, at least on initial recognition". Our reading of this suggests the discussion paper posits that the market value measurement objective is less relevant at subsequent measurement, which seems inconsistent with the paper's overall premise.

Our members suggest that the subsequent measurement of assets and liabilities is even more important than at initial recognition because of the vagaries involved. For practitioners, guidance for measuring fair value at initial recognition would have been extremely valuable. Exploratory analysis such as that undertaken in this discussion paper may have been more useful at the subsequent measurement phase where more uncertainties exist. This suggestion is in line with the discussions in paragraph 130.

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 that in theory where markets are considered efficient, there can only be one market (fair) value for an asset or liability. However, as noted in paragraph 137 further research is required to provide more a conclusive assessment of market versus entity-specific objectives.

The possibility of the existence of more than one market (fair) value should be more fully explored. For example, our members have posited that in their experience, when companies trade their shares on different exchanges (eg London and Hong Kong), price variances can be experienced. These variances seem to be small and short lived and occur due to the markets not operating at the same time or using the same currency. Our members suggest that this occurrence is common and as such, the relevant value would depend on the relevant market in which the shares are traded. One issue that needs to be explored is the treatment of such differences in fair value, including whether they should be recognised immediately.

As such, we believe that the discussion paper continues with the underlying assumption that only one fair value exists just as it implicitly assumes that markets are efficient, which is not necessarily true in practice.

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.

Our members have provided us with mixed views in relation to this question. While some members agree, others suggest that the promise to pay does not have the same fair value whether it relates to an asset or a liability on initial recognition. On initial recognition, the price paid or promised, should reflect the fair value. However, if the amount is merely promised, variances may arise if the cash flows are discounted using different rates, which would reflect entity-specific measurement objectives.

While we understand that this latter view is "not consistent with the concept of fair value as it has been proposed in this paper" (paragraph 143), unless discount factors are as objective as the fair value concepts being posited in this discussion paper, we perceive that differences in measurement will arise.

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.

Nothing has come to our attention to suggest that these proposals are inappropriate.

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 agree that the best market source on initial recognition is the market in which the asset or liability being measured was acquired or issued.

Based on our members' observations we believe that variations which may arise from different markets are generally not significant. However, this exploration may be useful in determining the appropriate bases for subsequent measurement.

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.

Nothing has come to our attention to suggest that these proposals are inappropriate. We agree that costs incurred by an entity to acquire an asset that can be recovered in the market for that asset should not be considered to be transaction costs, but rather should be used to determine fair value.

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.

We agree that when more than one measurement basis achieves an acceptable level of reliability, the most relevant of these bases should be selected.

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.

Nothing has come to our attention to suggest that these proposals are inappropriate.

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.

Based on the arguments presented in this discussion paper, we 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. We note that this discussion paper is very highly geared towards the use of fair value. Our members have suggested that the discussion paper would have been more useful if it spent less time justifying fair value at initial recognition and provide consistent and high quality application guidance. This is especially the case for items which are not quoted on a market, which our members have been most concerned about.

Further, the relevance of fair value as the measurement basis to be applied on initial recognition is so intrinsically tied with subsequent measurement issues that our members believe the only way to make an informed decision about the benefits of using fair value on initial measurement is to consider them in any conclusions made. We do not understand how subsequent measurement issues can be excluded from these discussions. Our view is that discussions about subsequent measurement can help the evaluation of appropriate bases of measurement generally, including whether and when changes in measurement basis can be justified. We believe that these discussions could have a reciprocal effect in helping determine the most appropriate basis for initial measurement, of which many would agree that fair value, where reliably measured, is most relevant at initial recognition.

Our members have also indicated that in addition to guidance on fair value measurement, a more valuable approach to the paper could have been to consider the extent to which fair value has been used in other aspects of accounting and provide a reasonable conceptual basis to justify these conflicting positions. For example the concepts of depreciation and impairment versus fair value measurement where changes in values would be taken through the profit and loss account. We would expect the results of such an analysis to provide reasoned arguments for developing a consistent measurement approach across all aspects of accounting.

Finally, we are also concerned about the implicit assumption of the existence of perfectly efficient markets whereby all public and private information is reflected in prices. We do not believe that all markets are perfect and hence the arguments made in this paper are not based on the practical reality. The arguments put forward seem to rely heavily on the existence of perfect markets.

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 paragraphs 106-114 of the condensed version and paragraphs 243-252 of the main discussion paper), and

(b) A measurement model or technique cannot be considered to achieve a reliable estimation of the fair value of an asset or liability when the estimate depends significantly on entity-specific expectations that cannot be demonstrated to be consistent with market expectations (see paragraphs 115-118 of the condensed version and paragraphs 263-268 of the main discussion paper)?

Please provide explanations for your views on these questions if they differ significantly from the conclusions and supporting arguments presented in the paper.

Based on the experience of our members, we would agree with this conclusion. However, we find it hard to envision a practical situation where only non-entity specific information could be used where no market exists for an item.

Question 16

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.

Based on the experience of our members, nothing has come to our attention to suggest that the paper's analyses and conclusions are inappropriate. However, we note that this discussion paper is very highly geared towards the use of fair value, which suggests that the tone is not completely objective.

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.

We 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.

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.

While we do not disagree with the hierarchy for the measurement of assets and liabilities on initial recognition, we are concerned about its inconsistency with those presented in the Draft FASB Statement of Financial Accounting Standard "Fair Value Measurement" and the Business Combinations Phase II project. We understand that at its 9 March 2006 meeting the FASB made various determinations about its Draft Statement of Financial Accounting Standard "Fair Value Measurement". One such decision was to affirm the guidance within Levels 2-4 of the FASB hierarchy and combine them to produce a 3-level hierarchy for both measurement and disclosure purposes. We assume that these developments will be reflected in further discussions of fair value.

We are concerned because, in our view, it would have been more efficient to ensure that a fundamental concept guiding the application of fair value be consistent. We understand that the IASB has not discussed this paper, but in order to maintain quality assurance and control over the conclusions made, we would have assumed that the IASB might have at least reviewed the paper for consistency. It would have been helpful if the variations had been identified and a discussion provided on ways to reconcile the differences in each hierarchy to provide a consistent approach. As such, our view is that the AcSB staff should have prepared this discussion paper in consultation with both the IASB and FASB staff to ensure a consistent approach from all standard setters.

Question 19

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.

CPA Australia makes the following additional comments in relation to this discussion paper.

Framework
Throughout this paper, there is a great deal of reliance on the Framework. Our view is that it is imperative that the convergence project regarding the Framework be finalised first.

Volume
We understand that there is a condensed version, but our members were concerned that if they did not refer to the full text, they would miss important details. Our members have suggested that the volume of information presented is inappropriate. Given that there is general agreement that fair value of assets and liabilities is the most relevant measure at initial recognition our members have suggested that their main concerns lie with subsequent measurement. As such, our members would have preferred a more succinct document which provided practical guidance on fair value measurement which reconciled differences between jurisdictions.

Due process
Our members have raised concerns about the AcSB developing this discussion paper without review by the IASB. Our members have indicated that they are not comfortable that only the views of the AcSB have been considered and would have preferred that input from IASB staff be provided to maintain a consistent approach to issues.

Future research
Our members have suggested that future research re "the use of deprival value when fair value cannot be reliably estimated on initial recognition" should consider Australian government organisations' experiences with the deprival valuation model articulated by The Steering Committee on National Performance Monitoring on Government Trading Enterprises – "Guidelines on Accounting Policy for Current Valuation of Assets" (December 1994). http://www.pc.gov.au/ic/research/perfmon/deprival/deprival.pdf