HSBC

Douglas J Flint
Group Finance Director

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Director Accounting Standards
Canadian Accounting Standards Board
277 Wellington Street West
Toronto
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Dear Sir

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

We welcome the Discussion Paper as a useful contribution to this key area of debate, and welcome the opportunity to take part in a comprehensive discussion on this subject. We believe that this is an area which requires careful consideration and further research before further accounting rules are produced.

General

We have a number of concerns around the approach that has been taken, and in general believe that there are too many gaps in the analysis at present to support the conclusions that have been reached in the Discussion Paper. We endorse the proposal to undertake the further research that has already been highlighted in the Discussion Paper, and would like to see further work on the areas of concern to which we draw attention in this response.

The Discussion Paper is of impressive length. In this response we have sought to highlight and comment on the issues we see as having the most significant impact, rather than supply detailed comments on each question.

Initial and subsequent recognition

We are concerned that the discussion on measurement bases has been subdivided into initial and subsequent measurement, and that this Discussion Paper deals only with the first in isolation. It is our view that initial and subsequent measurement issues are fundamentally related and should be considered together. As the Discussion Paper acknowledges, significant conceptual issues arise on measurement of the initial transaction even where made on an arm's length basis, however the issues that arise on the subsequent measurement of many transactions at 'fair value' are much more challenging. The Discussion Paper acknowledges that any conclusions

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drawn in this first discussion paper will need to be revisited in the light of the discussions around subsequent measurement; we agree, but believe that it could require a fundamental reassessment.

In the comments which follow, we have been mindful of the issues arising on subsequent measurement.

Fair value as the superior measurement basis for all transactions

We believe that the rationale on which the Discussion Paper's conclusion that 'fair value' is the superior measurement basis in all cases is flawed. We believe it is important to put 'fair value' in the context of this being a defined term rather than as a literal expression of the attributes it purports to represent. This is because, in the accounting context in which the term is used, it is based on a hierarchy of rules which do not necessarily result in a measurement value which is realisable in cash. This would be particularly the case for example where the size of the position held is not representative of the normal market size quoted on traded markets.

We believe that 'fair value' does provide relevant and objective information for certain types of transaction, particularly where financial instruments are traded for short term price performance in deep and liquid markets and the position held is representative of normal market size. The effort taken in such financial services activities to ensure that the market and non-market observable inputs to valuation models, and the models themselves, remain robust and valid, demonstrate that this is a complex area, critically dependent on the availability of reliable information.

There are, however, many types of transaction for which deep and liquid markets do not exist, and this is happening increasingly as products are structured to meet the needs bespoke of counterparties. There is therefore a lack of sufficient market transaction data on which to base 'fair values'. While there are many significant examples in financial services business, we believe that this is a point of general relevance to most business activities. In such cases, 'fair value' measurement has little connection to the economic process by which value is created in such businesses, and generates estimated values which cannot be realised and which are therefore merely indicative. In such cases, 'fair values' lack relevance to the business activity, and calculated 'fair values' may not represent the measures they are purported to represent, i.e. will be unreliable for financial reporting purposes. In these instances we believe that the merits of historical cost measurement (discussed below) far outweigh the informational content of estimated notional 'fair values'.

The pro 'fair value' argument rests on the assumption that markets are perfect or near perfect, and as a result, there can only be one market or 'fair value' for an item on any given date. The Discussion Paper distinguishes the market value measurement objective, whereby a price would be obtained which results from an open and active competitive market process, from what is termed the 'entity–specific measurement objective', with the latter reflecting different assumptions and expectations to those reflected in the market price. As a result, the presumption is made that the 'fair value' will always be more reliable and relevant.

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We do not believe that this presumption is compellingly justified in the Discussion Paper. We challenge the notion that there is one market value or 'fair value' at any point in time, as market values frequently represent ranges within which entities with different motivations, expectations and financial circumstances may be willing to trade. The thinner and less transparent the market, the less reliable, more volatile and potentially wider this range will tend to be. Furthermore we believe that most market values are a mixture of market and entity specific factors, and find the separation of the two overly simplistic.

The Discussion Paper acknowledges this difficulty in the discussion of 'Bid-Asked Spreads', when it states that '..when there is a wide bid-asked spread...one may need to look to other sources to estimate fair value in that range'. The difficulty presented by different prices in different markets, with differential access and information availability in respect of those markets, is also discussed in the Paper, but these issues are not resolved. We welcome the acknowledgement in the Discussion Paper that further research on price differences in multiple markets would be justified.

Historical cost model

We do not believe that the merits of the historical cost model have been given sufficient emphasis for certain types of business activity, particularly where there is no deep and liquid resale market. While this is a point of relevance to business in general, we note that it is particularly relevant to financial services (for example most consumer and commercial loan portfolios, customer deposits and retail credit card transactions).

The Historical Cost model provides objective and relevant information about the cash received or paid in respect of transactions, and about the contractual cash flows payable or receivable, including contractual interest on financial instruments, in the periods in which those cash flows arise. It is this close relation to the cash flows actually occurring in the business that makes the measurement both relevant and reliable in these types of business. 'Fair values', on the other hand, factor in future expectations of cash flows to form a theoretical estimate of current market value. On initial recognition in an arm's length transaction, one may not expect significant divergence, subject to practical concerns about the availability of an actively traded market and a 'single market price', however as a basis going forward for the types of business activity mentioned above, a 'fair value' estimate quickly becomes less reliable and objective, and lacks relevance to the process by which economic value is created in the business. For these types of financial instruments, 'fair value' calculation becomes a theoretical exercise in estimation and lacks relevance and reliability for the users of financial statements.

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Proposed hierarchy for the measurement of assets and liabilities on initial recognition

We do not agree with the proposed hierarchy of measurement bases, as this is grounded in the belief that 'fair value' is always the most relevant measure. The Discussion Paper argues that when other measurement bases are used as substitutes for 'fair value' on initial recognition, they should be applied on a basis that is as consistent as possible with the 'fair value' measurement objective. As our comments above suggest, we do not believe that this is necessarily the case. We do agree, however, that when it is not possible to estimate a 'fair value' reliably then it may well be that the most relevant measurement basis is not 'fair value'.

Next steps

We would like to understand the proposed due process around the Discussion Paper, in particular how the discussion and the conclusions reached will influence the development of the joint conceptual framework.

We are very interested to take part in further discussion on this significant area of accounting debate, and thank the board for its efforts in producing the Discussion Paper.

Yours sincerely

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