EFRAG
European Financial Reporting Advisory Group

19 July 2006

Director, Accounting Standards
Canadian Accounting Standards Board
277 Wellington Street West
Toronto
Ontario M5V 3H2
Canada

Email: ed.accounting@cica.ca

Dear Sir, Madam,

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

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the Discussion Paper *"Measurement Bases for Financial Accounting – Measurement on Initial Recognition"* (the paper).

We welcome the publication of this discussion paper. It has provided an opportunity for those interested in the future direction of accounting to have a comprehensive, global debate on a key issue: measurement on initial recognition. There now needs to be a comprehensive, global debate on all aspects of measurement—not just initial measurement—before any major changes to the existing measurement model are proposed.

The main conclusions in the paper are that all assets and liabilities should be recognised initially at fair value where fair value can be measured reliably. Where it cannot be measured reliably, current cost should be used. As a last resort (ie if current cost cannot be measured reliably either), current practice (ie historical cost, with exceptions for, for example, financial instruments) should be used. As this would be a major change to existing practice, it is important that the reasoning behind the conclusion is correct, comprehensive and persuasive. However, we have a number of fundamental concerns regarding the reasoning and conclusions in the paper. Those concerns, together with our other comments, are set out in the appendix to this letter.

We would particularly like to emphasise the following points.

- In our view the fact that the paper focuses exclusively on initial measurement represents a serious weakness because we think it is difficult—and probably inappropriate—to draw firm conclusions about initial measurement in isolation from subsequent measurement.

- The basic assumption of most of the discussion in the paper seems to be that perfect markets—or at the very least efficient markets (by which we mean very active and liquid markets that involve low transaction costs—exist for every asset and liability, yet that is the exception rather than the norm.[1] Or maybe the assumption made is that the most appropriate measure for any asset or liability is the 'efficient market measure' of that asset or liability even if an efficient market does not actually exist for the item involved. Whatever the assumption is it needs to be made explicit, then explained and justified persuasively, which it is not at present. The alternative is that the discussion should take into account what markets are really like. Such a discussion would consider why differences between cost and fair value (as defined) arise and what those differences mean for the relevance of alternative measurement bases.

- The paper reaches various tentative conclusions about reference markets, the unit of account, transaction costs etc. Those conclusions will all have an effect on the information that is provided in the financial statements about the financial performance and financial position of the reporting entity. Different conclusions on the aforementioned issues would result in different—we suspect in many cases materially different—information being provided about financial performance and financial position. Therefore, in order to be able to comment coherently on the conclusions the paper has reached on these issues, we need to understand what view of the entity's financial performance and financial position the paper believes the financial statements should portray—such an explanation would enable us to comment not only on how successful the proposed approach is in enabling the financial statements to provide that view but also on whether the paper is focussing on what we consider to be an appropriate view of financial performance and financial position. Unfortunately the paper does not contain such an explanation.

- We think that a number of important statements made in the paper are neither generally accepted nor justified in the paper. We are also not convinced by the reasoning underlying a number of important conclusions. For example—and probably most important of all—we are not convinced by the arguments advanced in the paper in support of the statements that (a) the market value measurement objective provides superior information to entity-specific measurement objectives, at least on initial recognition (paragraph 60) and (b) fair value is more relevant than measurement bases that depend on entity-specific expectations (paragraph 102). If the arguments in the paper are the only arguments in favour of those statements that exist and have been expressed in the paper in the best way possible, we do not understand how the paper could have reached the conclusions it has.

For the above reasons we believe that what is now needed is a comprehensive global debate on measurement that addresses the issues raised in this letter. That debate would need to reach conclusions about some overarching issues (such as, for example,

[1] For simplicity we will henceforth refer just to 'efficient markets'.

what particular view of an entity's financial performance and financial position are we trying to portray in the financial statements), and would then need to deduce from those conclusions more detailed conclusions about measurement. We think it is essential that this debate start as soon as possible.

We would like to end this letter by thanking your Board and its staff for preparing this paper. Although we have criticised some of its content, there is no doubt that it has started a debate that we have been asking for for a long time and we are grateful to you for achieving that.

We hope that you find our comments helpful. If you wish to discuss them further, please do not hesitate to contact Paul Ebling or myself.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

APPENDIX

This appendix contains our detailed comments on the paper. In preparing these comments, we have focused almost exclusively on the condensed version of the paper. As such, when we mention a paragraph number, we refer to the condensed version of the paper unless stated otherwise.

We have also restricted ourselves at this stage to making only high-level comments on the paper.

EFRAG's general comments

1 The paper focuses exclusively on initial measurement. We think this is a serious weakness.

- The measurement debate seems to us to be to a large extent about the allocation of gains and losses to reporting periods. (For example, assuming we buy an asset for 100CU and sell it three years later for 300CU, how that item is measured in the financial statements at the end of years 1 and 2 will determine how that 200CU gain is allocated between the income statements of years 1, 2 and 3.) We think it is difficult if not impossible to draw firm conclusions about initial measurement (in effect what the day 1 gain or loss should be) in isolation from subsequent measurement (in effect what the gains and losses should be in years 1 to 3).

- Focusing exclusively on initial measurement means that an important issue—whether (and in what circumstances) it is appropriate to change the basis on which an item is being measured subsequent to initial recognition—is not discussed in the paper. That is a pity because we think that issue could have implications for the initial measurement discussion.

2 Much of what the paper says about the relevance of market value measurement objectives and fair value appears to assume that efficient markets (or at the very least active and liquid markets that involve low transaction costs)[2] exist for every asset and liability.

(a) It may be that the authors believe that efficient markets exist in the vast majority of cases. However, even if that is the case in North America, it is not the case for most markets in most parts of the world. Typically those markets are neither highly liquid nor, in many cases, very active; and the transaction costs are often significant.

(b) Alternatively, it may be that, despite initial appearances, the paper believes that the relevance of market value measurement objectives and of the fair value measurement basis is not dependant on the existence of efficient markets. If that is the case, it would have been helpful had that been made clear in the paper because it is a view that many commentators will not

[2] For simplicity we will henceforth refer to such markets as 'efficient markets'.

realise the authors hold. Such a view also needs explaining because many commentators will not understand the reasoning behind it.

We think that many of the arguments used in the paper to justify the relevance of market value measures, and fair value in particular, do not apply if there is not an efficient market for the item involved. Although paragraph 114 seems to accept this when it admits that an exchange price when there is no market price may not faithfully represent the properties of market value, generally the paper seems to view the absence of efficient markets as an issue that affects the reliability—but not the relevance—of the fair value number.

EFRAG believes that, if we are all to reach a better understanding of and common agreement on measurement, there needs to be a debate about measurement that recognises that markets are rarely efficient. This is also important because the initial measurement debate is interesting only when historical cost and fair value are different, and market imperfections and transaction costs are often the reason why these differences arise. We therefore need to consider exactly why such differences arise and what that means in terms of the relevance of the initial measurement.

3 Chapter 2 suggests that the various measurement bases available should be assessed by considering criteria derived from the Framework, in particular, the objective of financial statements and the qualitative characteristics of financial information; in other words, by considering user needs. We agree with this view because measuring assets and liabilities in financial statements is not an end itself; it is merely a means to an end—a means of providing information that is as useful as possible to users. However, we have some concerns about how the paper applies the user needs test. In particular:

- The paper is right to focus on the objectives of financial statements. However, although the paper refers to stewardship in Chapter 4, it focuses primarily on the decision-usefulness objective. This is consistent with the tentative decisions taken by the IASB and FASB in their Framework project, but is not an approach with which we agree; in our opinion, financial statements have a stewardship and accountability objective that is separate from the decision-usefulness objective. We think this difference of view could have important implications for the measurement debate.

- The paper argues that the decision-usefulness of the financial statements is maximised if the entity's performance is measured against market value. It does not however appear to justify that view. This is a key issue that needs to be explored and debated fully. For example, if the objective is to provide information that enables users to make assessments about future cash flows, it is important to understand why some believe that measures involving no entity-specific inputs are more relevant than measures involving some entity-specific inputs. Similarly, bearing in mind that those future cash flows that are derived from operating activities will be derived from transactions, it is important to understand why some believe that measures that make accounting and financial performance less transaction-based have superior relevance.

4 Towards the end of the paper, various tentative conclusions are reached about the unit of account, reference markets etc. We find it difficult to comment on these conclusions in a coherent way because we do not understand (as it is not explained in the paper) what the paper sees as the objective of fair value measurement in terms of precisely what view of the entity's financial performance and financial position the paper believes the financial statements should portray.

For example, it sometimes seems to us that the arguments used by those supporting the extensive use in the financial statements of fair value can be summarised as follows:

- Measures that are updated to reflect current conditions ('up-to-date measures') are bound to be more useful to users than measures that are not updated (ie historical cost), assuming they are sufficiently reliable.
- If up-to-date measures are to be used, the less subjective they are the better.
- That means it is better to use market-based up-to-date measures than entity-specific measures.
- Most of the other issues that need to be addressed—such as unit of account, reference markets etc—should be decided on by applying some pragmatic 'rules' such as choose the option that maximises the use of market-based data wherever possible, recognition of day one profits is best avoided if possible, etc.

We have difficulty with this type of approach because we believe that the different measurement bases (and choices over things like unit of account and reference markets) result in different financial performance and financial position recognition models and we are not sure how to choose between those recognition models without considering user needs in much more detail than the paper does.

In this context we note that there are occasional references in the paper to the sort of information the paper's authors believe the financial statements should provide—for example paragraph 124 talks about the desirability of distinguishing between the net income effects of activities relating to the acquisition and creation of the asset and the net income effects of subsequent activities. However, these references are not brought together into a coherent whole, nor is any attempt made to justify them in terms of user needs.

EFRAG's responses to the questions asked in the 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 paper lists the following measurement bases: historical cost, current cost (ie reproduction cost and replacement cost), net realisable value, value in use, fair value and deprival value. We agree that the list is comprehensive. However, if any of the listed measurement bases are defined narrowly, the list would need to be expanded to include other definitions of that measurement basis. For example, if 'fair value' is defined as, say, an estimated market exit price, estimated market entry price, estimated market mid-price etc would need to be added to the list.

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)?*

We have not analysed the terms, definitions and interpretations in sufficient detail to be able to reach detailed conclusions about them. However, based on our initial consideration, we do have a number of concerns:

(a) *Historical cost*—We note that paragraph 34 defines the historical cost of an asset as the fair value of the consideration given to acquire that asset at the time of the asset's acquisition. We are concerned about how the phrase "at the time of the asset's acquisition" might be interpreted when, say, the asset is being constructed over a period of time. In particular, we have seen it suggested that the date of acquisition of a constructed asset is the date it becomes operational, which would mean that under the paragraph 34 definition the historical cost of an asset that is constructed over a period of time would be the fair value—at the date the asset becomes operational—of the consideration given to build the asset. That is *not* in our view the historical cost of the asset. We think the paper assumes that in a construction contract there is a single transaction; however, in our opinion there is not a single transaction, so the choice of measurement date is not as straightforward as the paper suggests. Either a different view needs to be taken of what is meant by 'at the time of the asset's acquisition' or the focus should be more on the accumulated cost incurred (perhaps excluding cost inefficiencies in certain cases, but that would need further thought) rather than the fair value of the consideration given.

(b) *Value-in-use*—Paragraph 44's definition of value-in-use does not make it clear whether value-in-use is to be based on entity-specific expectations of estimated future cash flows. As paragraphs 164 and 166 explain, it is usually viewed as an entity-specific value; however, as paragraph 166 explains—and FASB's discussion (in its Fair Value Measurement Guidance draft standard) of the non-entity-specific 'fair value-in-use' makes clear—that is not necessarily so. The term therefore needs to be defined more precisely before it is possible to identify its strengths and weaknesses as a measurement basis.

(c) *Deprival value*—Paragraph 50 states that the term 'deprival value' is not defined or used in IASB standards. Although deprival value is not specifically mentioned in IFRS, it does underlie the principles in IAS 36.

(d) *Fair value*—The definition in paragraph 46 is the existing definition in IFRS for the fair value of an asset. However, as FASB's work on fair value measurement guidance has revealed, that definition says little about what exactly the notion of fair value is attempting to capture. Is it a market-based measure or, for example, an entity-specific measure? When there is more than one market, what exactly is it that fair value is attempting to reflect? (Or, in other words, which reference market should be used and why?) Is it about entry value or exit value? (We recognise that this issue could be viewed as a reference market issue as well.) We recognise that, as one reads the paper, the answer to these questions quickly becomes clear, but our point is that they are not clear from the definition proposed. According to some of the comments in the discussion paper, fair value is superior to other measurement bases only if these questions are answered in a particular way, which suggests that there is a need to define fair value more precisely before comparing it to other measurement bases.

We also disagree with the statement in paragraph 48 that there "seems to be general acceptance among standard-setters that the objective of fair value measurement is to represent the market value of an asset or liability at the measurement date." We think only a few standard-setters accept that is the objective of fair value measurement; most standard-setters have not yet taken a view and are waiting for those "few standard-setters" to explain fully the reasoning that leads them to that conclusion.

Finally, we have reached the conclusion that, if it is decided that the measurement objective should be to represent the market value of an asset or liability at the measurement date, it would be better to use a term other than 'fair value' to describe that measure because the term 'fair value' carries too much 'baggage' for there to be a purely technical discussion of the subject. For example, many people have been using the term for years and to them its meaning is clear but different from the meaning that the paper, the IASB and FASB attaches to it. Furthermore, in some people's minds the word 'fair' brings with it an expectation about the value that is not fulfilled by fair value as defined in this paper. We recognise that the authors considered this point in developing the paper and rejected it, but we think they are underestimating the problems the term causes.

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 that the main sources of the differences between the identified bases for measuring assets and liabilities on initial recognition are (a) the 'value-affecting properties and market sources' identified—the unit of account, the existence of different markets, information asymmetry, bid-ask spreads and transaction costs, and market accessibility and related issues—and (b) differences between market-based measures and entity-specific measures. It follows that those factors should be taken into account in the measurement debate. However, many of these factors seem to have been ignored, assumed away or not taken fully into account in the paper's analysis, reasoning and conclusions. This seems odd, not least because the only time that initial measurement is really interesting is when there are differences on initial recognition between the various possible measurement bases. For that reason we would have expected value-affecting properties and market sources to be at the centre of the debate.

We note that paragraph 62 of the condensed version of the paper states that an a priori expectation is that there would be only one fair value for an item on measurement date, and much of the subsequent discussion is then based on this expectation. Yet it is clear from the paper (see paragraph 137 of the longer version for example) that the authors have not been able to reconcile the view that there is only one fair value with the observable evidence. (This issue is also discussed in our answer to question 7.) This seems to represent a flaw in the paper's analysis.

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)?

<u>Question (a)</u>

We note that paragraph 54 states that the market value measurement objective is reasoned from finance literature on market prices and efficient markets. We think it would have been useful had the paper gone on to explain why a convention made in finance literature is appropriate for financial reporting bearing in mind that in the real world the vast majority of markets are not efficient markets. This is important because commentators will struggle to understand how a market value measurement objective justified solely by finance theory would help improve the financial statements of entities that operate in an economic world that is far removed from the underlying finance theory assumption that markets are efficient. In any event we understand that the convention is now recognised by finance theorists to be an over-simplification because even liquid markets incorporate a lot of other components, including rational and irrational bubbles and human behaviour.

Question (b)

Paragraph 54 explains that the market value measurement objective is to reflect the price that would result from an open and active competitive market process, in other words from a market as defined in paragraphs 55-56. That explanation is helpful, but:

(a) as we have explained elsewhere in this letter, we are not persuaded by the reasons given in the paper that that is an appropriate measurement objective for financial statements;

(b) we assume the authors—and others that support this particular measurement objective—realise that only a few of the markets that exist around the world meet the definition in paragraphs 55-56. This makes it even more important that those wishing to use the definition and the fair value measurement objective have convincing arguments for wishing to do so; and

(c) the use of this definition seems inconsistent with a number of the other comments made in the paper. For example, paragraph 108 observes that "every day people get bargains or pay more than fair value for goods and services"; that would of course only be the case if the transaction has taken place on something that is not a market as defined. A similar point can be made about the paper's references to the existence of multiple markets.

Question (c)

(a) Although paragraph 102 states that "it has been reasoned that the fundamental objective of fair value is to reflect the market value of an item on the measurement date," we are not sure that is a correct statement. The familiar definition of fair value set out in paragraph 46 actually permits various possibilities, but the paper goes on to claim (in paragraph 48) that "there seems to be general acceptance among accounting standard setters that the objective of fair value measurement is to represent the market value of an asset or liability at measurement date"—and that seems to be the end of the debate. We think this is a rather pointless debate about labels. If one starts by attempting to define fair value, we suspect that there is not a single correct view as to what 'fair value' represents—the term can mean what one wants it to mean. On the other hand, if one starts by concluding that a measurement basis that exhibits certain specified attributes is the one that should be used in financial statements and henceforth that measurement basis will be known as 'fair value', there will probably be a single correct view as to what 'fair value' means.

(b) Paragraph 102 states that "the tentative conclusion developed in chapter 4 is that the market value measurement objective has important qualities that make it superior to an entity-specific measurement, at least on initial recognition. …Hence, fair value must be considered more relevant than measurement bases that depend on entity-specific expectations, as long as it can be reliably measured." As explained elsewhere, we do not believe that the arguments used by the paper to justify these tentative conclusions are persuasive.

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.

We are very uncomfortable with the paper's definition and discussion of entity-specific measures.

(a) As explained more fully in our answer to question 16, we believe that the paper appears to use the term 'entity-specific' inconsistently—and in some cases incorrectly.

(b) We think it is an oversimplification to characterise every measure as either market-based or entity-specific, because there is a category of data that is neither market-based nor entity-specific and we think that could lead to a category of measure that is also neither market-based nor entity-specific. For example, mortality tables are neither market-based data nor entity-specific.

(c) The assumption seems to be that entity-specific data is more subjective than market-based data, but that is not necessarily the case. For example, a manufacturer may have data about the failure rates of its products. Such information is not subjective—it can be verified by independent third parties—but is not information to which market participants generally have access.

(d) We also think it is a simplification to think of entity-specific measures as being based on management intention. There are often a number of different ways that an entity can in theory extract value from an asset or settle a liability, but in practice not all those ways are available to the entity, either because it is not capable of pursuing them or because they are not realistic options for other reasons. Entity-specific measures are a means of taking into account those abilities and of putting aside options that are not realistic.

    Furthermore, in the context of the discussion in this paper—which focuses exclusively on initial measurement—it is difficult to see how management expectations and intentions are of any relevance at all for some entity-specific measures (such as cost).

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 do not agree with the comparison of market and entity-specific measurement objectives. We commented earlier that we think much of the discussion assumes the existence of efficient markets and we think the discussion of market and entity-specific measurement objectives is particularly guilty of this; indeed it appears to us that the efficient market assumption is fundamental to the conclusion reached. That does not mean that the conclusion is necessarily wrong—further analysis is necessary—but we suspect it might mean that the market value measurement objective will generally be more relevant than entity-specific measurement objectives only when there are efficient markets. That will be the case only rarely.

Generally speaking, we found this section of the paper disappointing because, rather than a discussion that focuses on the criteria identified in chapter 2 and uses those criteria to discuss the advantages and disadvantages of the two measurement objectives, the paper seems simply to assume, without explanation, that a measure that is a very good proxy for market value is a more relevant measure for accounting purposes than a measure that is not a good proxy for market value. For example:

(a) market-based prices are only spot prices, and simple economics suggests that spot prices are the marginal price that achieves market equilibrium between market participants that have different views as to the value of the asset or liability involved. A market-based measure of an item does not therefore reflect the value of the item from the perspective of all market participants, just its value to the 'marginal' market participant. We think it would be helpful to explain why the information provided to users is improved by using marginal values rather than amounts that are closer to the items' true economic worth.

(b) a recent IASB standard (IFRS 7) and a recent exposure draft (ED 8) have adopted a 'through the eyes of management' approach, and the IASB has argued strongly in the Basis for Conclusions sections that applying a 'management approach' in such circumstances results in improved financial reporting. It might be informative to articulate why a 'management approach' to measurement (ie the use of entity-specific measures) is not thought to be equally useful.

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.

Our understanding of paragraphs 135-137 of the long version of the paper is that, although the authors believe there should be only one fair value for each asset or liability, they have not been able to reconcile this view with what they observe to be reality. That does not surprise us because, although market forces will eliminate differences between the prices on different markets if those markets are efficient, there will be inconsistencies between market prices on inefficient markets and very few markets are efficient. The paper itself states (in paragraph 136 of the long version) that the proposal referred to in (a) is not correct.

We agree with the suggestion in (b) that further research is needed, although we think that suggestion applies to many of the issues discussed in the paper.

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 are very uncomfortable about the possibility that changes in the reporting entity's own credit risk should be reflected in the carrying amount of their liabilities. We recognise that this discomfort relates to subsequent remeasurement and some commentators will argue it has therefore no relevance to this paper, which deals only with initial measurement. However, we are not so sure. We think we have heard all the arguments for taking changes in an entity's own credit worthiness into account in arriving at fair value, but are still not persuaded that recognising such changes in the entity's balance sheet and income statement would improve the quality of the information provided by those financial statements. This suggests to us that there might be some sort of fundamental weakness in the way the fair value debate is being approached. It even makes us wonder whether the question posed in question 8 is the right question to ask. This is another reason why a comprehensive global debate on measurement is needed.

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.

If an entity buys a portfolio of instruments with the intention of holding that portfolio largely intact and then selling it, it seems reasonable that the unit of account on initial recognition and subsequently should be the portfolio of instruments. On the other hand, if the entity is acquiring individual instruments, bundling them together and selling them as portfolios (or buying portfolios, unbundling them and selling individual instruments), the unit of account issue will determine when the bundling/unbundling profit or loss is recognised. As explained in our opening general comments, we believe that to answer question (a) in a way that is consistent with other aspects of the chosen accounting model, we need to understand precisely what view of the entity's financial performance and financial position the paper believes the financial statements should portray. That is also true of the other questions asked here. For example, depending on exactly what view is to be portrayed, it might be appropriate to resolve the unit of account issue by focusing on the economic constraints to which the entity is subject and economic opportunities to which it has access.

Furthermore, in our view the issues addressed in this question cannot be answered without also considering subsequent remeasurement—which is why we believe that initial measurement and subsequent measurement need to be addressed and resolved together.

Finally, we have a detailed observation on the proposal that the unit of account should generally be the unit of account in which the asset (or liability) has been acquired (or incurred): how would this be implemented if the asset or liability has been acquired or incurred in a variety of units of account?

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 believe that further thought is needed on this part of the paper because, as explained in our answer to question 7, it does not seem appropriate to base so much of the analysis on an assumption (that there is a single fair value) which observable evidence shows is not valid.

As explained in our opening general comments, it is difficult to comment on the specific detailed proposals in the paper in paragraphs 75-82 until we understand precisely what view of the entity's financial performance and financial position the paper believes the financial statements should portray.

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.*

Chapter 3 of the paper contains what we consider to be a comprehensive list of all possible measurement bases. At that point the fair value is defined in fairly broad terms such that different treatments of transaction costs are possible. The paper goes on to narrow the meaning of the term 'fair value' such that transactions costs are not included. That seems to us to be reasonable as long as the chapter 3 list is then extended to include alternative versions of fair value that involve a different treatment of transaction costs, and the narrowly-defined fair value are compared against, inter alia, the alternative versions, including those that involve a different treatment of transaction costs. .

As we have already made clear in our earlier answers, we think it is difficult to comment on many of the detailed proposals in the paper until we have a clearer understanding of what view of the entity's financial performance and financial position the paper believes the financial statements should portray. In the absence of such an understanding, we feel able to make only the following observations on the issues raised in the question:

(a) When an entity buys an asset that it intends to use until it is exhausted, that entity is concerned only about the total cost of that asset and the return it will make on that total cost. It is indifferent to which part of the cost is a transaction cost and which part is the consideration given for the asset itself. In such circumstances, the paper needs to explain more fully and more persuasively why its proposed treatment of transaction costs is appropriate. For example, is it that the authors believe that, although the reporting entity may be indifferent as to what makes up that total cost, users are not indifferent? Or is it, for example, that the authors' proposal is based on pragmatism?

(b) The discussion of transactions costs in paragraphs 86 and 87 attempts to differentiate between transaction costs that are recoverable in the market place and transaction costs that are not. We do not think this differentiation as currently expressed in the paper is workable. The example given in the paper (paragraph 87) concerning import duties seems to be about pricing rather than anything of relevance to the selection of an appropriate measure.

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.*

Compared to the existing Framework, the paper places greater emphasis on 'relevance' than on 'reliability'. This—and the comments we made about stewardship and accountability at the beginning of this appendix in the first bullet of paragraph 3 of our general comments—shows that it is difficult to discuss any significant aspect of measurement in isolation, and why it is so important that a comprehensive debate takes place.

We also note that there appear to be significantly different views as to what reliability actually means and how it interacts with the relevance test. For example:

(a) it has been suggested to us that information that is based on a 'through the eyes of management' approach is less reliable than information that is based on a more independent view of the reporting entity. There seems also to be some confusion as to whether a measure that is more subjective than another is necessarily less reliable.

(b) some respondents believe that reliability is actually a characteristic of relevant information—in other words, that measures that are not reliable cannot be relevant. The Discussion Paper does not go that far, but it does stipulate that any measure used must be both relevant and sufficiently reliable. The IASB and FASB in their ongoing framework project seem likely to suggest however that measures can be relevant even if they are not reliable (or to be more exact, representationally faithful).

(c) the paper seems to suggest that the use of allocation techniques reduces the reliability of information. It also suggests that if prerecognition costs are not capitalised, the amounts that are capitalised are a less reliable measure. Some other commentators believe that allocation techniques and the non-capitalisation of prerecognition costs do not make measures less reliable.

(d) some people believe that 'reliability' is not an absolute characteristic but a relative one; in other words, that the reliability of a particular measurement basis can only really be judged in terms of the alternatives available.

We think it would be useful if these sort of issues were addressed and clarified as soon as possible so that they cannot continue to be a cause of confusion and disagreement.

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 with this part of the paper.

In our view, in order to operationalise the reliability test it is necessary to reach some sort of broad agreement on what is meant by ‘sufficiently reliable’ because at the moment there are significant differences of view. The paper does not address this issue.

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.*

We do not believe the paper has made a sufficiently strong case for concluding 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 believe that one reasonable way that can be used to evaluate the various measurement bases is to focus on the gains and losses that arise under each basis and ask what those gains and losses tell users of the financial statements about the financial performance of the entity. The paper, for example, seems to be arguing in paragraph 124 (and earlier in paragraph 59) that gains and losses arising on assets and liabilities should be allocated to the performance statement(s) in such a way that those gains and losses arising from market movements are recognised as soon as they arise and those gains and losses arising because the reporting entity's position is different from the market's are recognised only as the entity's strengths and weaknesses give rise to above average and below average returns. This might make sense when efficient markets exist—there seems to be some logic in not anticipating gains and losses that arise from the entity's use of its strengths and weaknesses, although it is reasonable to ask why the decision-usefulness of the information is improved by recognising gains and losses arising from market movements immediately. However, the issue should be discussed in the context of the 'real world' of inefficient markets; in such circumstances, recognising assets and liabilities at fair value on initial recognition will result in measurement inadequacies and market imperfections being recognised as day one gains and losses and it is not clear why that improves the decision-usefulness of the information.

We recognise that some commentators would argue that the focus in the previous paragraph on the implications for the gains and losses being recognised is wrong; instead they would argue that under the asset and liability approach one simply measures all assets and liabilities at their fair value—because that is the most appropriate portrayal of the entity's financial position—and a performance reporting presentation should then be chosen that extracts as much useful information as possible out of the gains and losses recognised. If that is the view held by the authors, it would have been better to state that view clearly and to explain the rationale behind it. We note also that such a view:

- assumes that market *exit* value provides the most appropriate portrayal of the entity's financial position and that, in our opinion, is an assumption that needs to be justified. We agree that a balance sheet prepared on a market exit value basis is probably a good indicator of a reporting entity's future cash flows if the entity is intending to (or is in the business of) selling its assets as soon as possible after the balance sheet date. However, most entities are not in that business; instead they nurture their assets and use them to generate cash flows in less direct ways.

- places considerable reliance on the performance reporting presentation's ability to extract useful information out of the fair value gains and losses being recognised; and

- highlights a much wider point, which is that decisions about measurement should probably not be taken in isolation from decisions about presentation and disclosures, because changes to the measurement bases used might require changes to presentations used and disclosures provided to ensure that users can extract the information they need from the new basis.

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.

We agree:

- that fair value on initial recognition is not capable of reliable estimation in some common situations;

- with the statement (in paragraph 106) that a few infrequent observable transactions do not necessarily constitute a market; and

- with the same paragraph's statement that a transaction price paid or received for an asset or liability will not necessarily be its fair value on initial recognition.

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 had a lot of difficulty with this part of the paper because we think its tone, language and drafting generally is not neutral. In our view, the strengths of fair value and weaknesses of historical cost are overstated and the weaknesses of fair value and strengths of historical cost are understated. If one looks beyond this and takes into account that usually there will not be an efficient market for the asset or liability involved, it seems to us that the arguments used are not very convincing. In particular, the arguments for rejecting historical cost as a surrogate for fair value on initial recognition seemed to us to be fundamentally flawed. As we have already mentioned, the debate about whether to use historical cost or fair value for initial measurement purposes is only a real issue when the amounts are different, so we would have expected the paper to have analysed the reasons for the difference before reaching the conclusions it has. Unfortunately, the paper does not do that.

Our concerns about the reasoning are however not limited just to what is said about 'fair value' and 'historical cost'. For example, the argument used in the paper to support the view that current cost has more informational value than historical cost—"historical cost purports to measure what was paid for an asset or received for a liability, while current cost purports to measure the most economic amount that rationally could have been paid or received on initial recognition"—seems open to challenge on at least two grounds. Firstly, it is not immediately apparent why current cost should in some way be a more rational amount than historical cost. Secondly, it is not explained why, even if current cost *is* "the most economic amount that rationally could have been paid or received", it follows that using the current cost measurement basis would result in more relevant information than the alternative bases available.

We also note that the paper appears not to be consistent in the way that it uses the term 'entity-specific'. Although historical cost is an entity-specific measure, it is different from other entity-specific measures and the arguments used in the paper to dismiss entity-specific measures do not in the main appear to us to apply to historical cost.

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 do not think the issue is as simple as the paper suggests, and we fear that the paper may have placed more emphasis on consistency with the fair value measurement objective than on analysing what best meets the interests of users. We say that because, in the circumstances in which it is not possible to estimate a fair value reliably, we question whether fair value is actually the most relevant measurement basis anyway. That is because the markets will usually be fairly inefficient and in such circumstances the arguments advanced to support the superior relevance of fair value may not apply.

We also have some difficulty understanding exactly when the paper envisages that a substitute for fair value will be used. For example, if entities were required to measure in its consolidated financial statements all acquisitions of subsidiaries at the fair value of that acquiree (as proposed by the IASB in its Bus Coms 2 Exposure Draft), we think your paper would require us to select a substitute for fair value and we think that substitute could well be historical cost. If that is not the authors' intention, this aspect of the paper would benefit from greater clarity.

Finally, we note that the paper has chosen not to call the substitutes for fair value 'fair value'. We support this approach because we believe that confusion can be caused by labelling as 'fair value' measurement bases that are not always good proxies for fair value but are being used as substitutes. The labels we use should highlight differences in methodology, not obscure them.

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 have no comment on the proposed hierarchy at this stage except to note that the discussion of the proposed hierarchy makes no mention of transaction costs and little reference to the discussion of the value-affecting properties.

EFRAG's other comments

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.*

(a) We agree with the statement made in the long version of the discussion paper that it is important to consider any capital maintenance implications of particular measurement bases. In addition to this we wonder whether it is appropriate to evaluate different measurement bases without first reaching conclusions on the underlying capital maintenance concept to be followed.

(b) Although the paper is described in the introductory material as a "preliminary investigation" and therefore could perhaps be excused for focusing exclusively on theoretical issues, it goes further than that and actually reaches some conclusions that do not contain any caveats about practicality—yet the paper contains no serious consideration of the cost-benefit implications of what is being proposed. That is unfortunate because we suspect that the extensive changes to existing practice that the tentative conclusions reached in the paper would imply could be time-consuming and expensive. It has, for example, been suggested to us that it would be necessary to implement new control systems and procedures to identify transactions that have taken place at something other than fair value (perhaps simply because prices have changed between order date and recognition date) and to ensure that to account properly for such transactions. Against these costs will need to be weighed the benefits that will arise, which means being much clearer about how the changes suggested will improve the quality of the information provided to users.