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EUROPÄISCHE VEREINIGUNG DER GENOSSENSCHAFTSBANKEN

EUROPEAN ASSOCIATION OF PUBLIC BANKS - EUROPEAN ASSOCIATION OF PUBLIC BANKS AND FUNDING AGENCIES

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COMMENTS ON THE DISCUSSION PAPER "MEASUREMENT BASIS FOR FINANCIAL ACCOUNTING – MEASUREMENT ON INITIAL RECOGNITION"

GENERAL COMMENTS

1. The European banking industry welcomes the opportunity which the Discussion paper provides to IASB constituents to give input into the revision of IASB's Conceptual Framework. Clearly, the measurement basis for financial accounting is one of the most controversial issues which will need to be debated when revising the Framework. Time needs to be taken to reflect on the various issues involved before moving forward. It is entirely appropriate, in these circumstances, for the IASB to enter into a dialogue with its constituents at an early stage in the process.

2. The measurement basis for financial accounting is a complex issue as it raises questions which are interlinked with other conceptual issues which are likely to be addressed in revising the Framework. The various measurement bases should, for instance, also be examined against the background of the purpose of financial statements (Whose needs are they supposed to meet?). This issue may be particularly relevant in the context of the measurement debate because, amongst other things, the needs of shareholders may not be the same as those of debt investors (including banks).

Obviously, as a matter of procedure, all interrelated issues cannot possibly be addressed simultaneously. They need, instead, to be dealt with sequentially in the first stage. However, pending a more thorough and holistic examination of the issues involved, it is difficult to make pertinent comments on the appropriateness – let alone superiority – of any one measurement basis.

3. The Discussion paper does not explain why the existing model of determining the value of assets and liabilities on initial recognition would need to be modified. Such an explanation would be helpful to understand where and how improvements could be made and which direction should be taken when developing a new approach.

4. The Discussion Paper addresses measurement on initial recognition, to the exclusion of subsequent measurement. Adopting this course is probably inevitable as one necessarily needs to start somewhere. However, initial and subsequent measurement issues are closely related to one another and will, therefore, need to be dealt with in an holistic way at some stage. The views expressed in our comment letter on initial recognition must, therefore, be considered as preliminary pending a discussion on subsequent recognition.

5. The reflections which are made in the Discussion Paper on Fair value sometimes seem to be self-contradicting. This is primarily so where a Day 1 profit or loss would result on initial recognition. We believe the definition of Fair value to imply a presumption that the price of a transaction which is concluded between two independent parties constitutes the best representation of Fair Value.

REPLIES TO SELECTED QUESTIONS

Q1. *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.*

IFRS contain various implicit references to a "Components Approach" to fair value measurement which basically relies on the idea that it may be possible to isolate various separate risk components which are inherent in a financial instrument and measure them separately. Several passages in IAS 39 and other standards indicate that such an approach is regarded as a useful – and even a recommended – measurement tool.

It is, therefore, surprising to note that a Components Approach has not even been mentioned in the Discussion paper as a possible alternative measurement basis that may be appropriate in some circumstances. It needs to be highlighted in this context that a Components Approach may be particularly useful to address issues of reliability where there is a lack of transparent liquid markets for financial instruments taken as a whole.

Q2. *Do you agree with the working terms and definitions, and supporting interpretations, of each of the identified measurement bases (see paragraphs 33-51 of the condensed version and paragraphs 77-96 of the main discussion paper)? If not, please explain what changes you would make. In particular, do you have any comments on the term "fair value" and its definition (in light of the discussion in paragraphs 46-48 of the condensed version and paragraphs 88-93 of the main discussion paper)?*

The Discussion Paper proposes a definition of "**historical cost**" that includes "liabilities are recorded at the fair value of the consideration received in exchange for incurring the obligations at the time they were incurred" (see page 26 of the Condensed Version, para 34). However, applying the concept of **"historical cost"** to liabilities is rather inappropriate. Furthermore, the proposed definition ignores the possibility that a liability may occur without any consideration having been received. It would probably be more accurate to refer instead to "the value at origination" of a liability.

We agree with the proposed definition of “**current cost**” (see page 28 of the Condensed Version, under paras 38 to 40) – “the most economic cost of an asset or of its equivalent productive capacity or service potential.”

The Discussion Paper proposes a definition of “**deprival value**” (or “value to business”) as “the loss that an entity would suffer if it were deprived of an asset” (see Condensed Version, page 30, para 49). “Deprival value” may be a concept which is familiar to economists. However, it has not been used so far in IASB accounting literature. One may, therefore, wonder if it is a concept appropriate to accounting.

The definition which is given to the concept of “**predictive value**” (see Condensed version, page 34) focuses exclusively on the expected rate of return and seems, therefore, to ignore execution risk (which is critical to transforming potential earnings into real money). We doubt whether this concept should be considered useful as it refers to a measurement basis which is not managed by the entity controlling the asset or liability.

Q6. *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.*

The Discussion paper concludes from the comparison which it makes between market and entity-specific measurement that any information which is not market-specific – and thus not accessible to all market participants – would be subjective and, therefore, be less important to users.

The Discussion Paper does not, however, clarify in a satisfactory way why market-specific models should be given preference over entity-specific measurement. The argument that the former would deliver more relevant information is not convincing. Discussions which are currently being held on management commentary (*Discussion Paper: Management Commentary*) and segment reporting (*Exposure Draft: Segment Reporting*) highlight, in contrast, the benefits of a "management approach" and emphasise that a management perspective delivers information which can greatly assist investors in making their investment decisions. Owners often know their assets better than anyone else and se should be able to value them more accurately. This makes an entity-specific valuation inherently superior, even if it may be difficult to verify by reference to market prices. This difficulty is removed in respect of initial measurement where the transaction price represents the point of equilibrium agreed between the buyer and the seller. In a banking context, the loan relationship manager knows customers personally which is of great importance in assessing the initial price of a loan and its subsequent recoverability.

Also, in the context of the debate on the merits of a full fair value accounting model it is often implied that measurement needs to be based primarily on market values. However, as no observable market prices are available for the majority of assets and liabilities, it is recognised within that context that their fair value must be calculated on the basis of valuation models – even though the choice of a "suitable model" among all the models discussed in finance literature and the setting of the applicable parameters are subjective management decisions. Given the Discussion Paper's view that entity-specific factors should, if possible, play no role in measurement, this represents a contradiction.

The Discussion Paper is neither consistent where it envisages that, if there are various different markets with different prices, measurement should be based on the best possible price for the individual entity in an accessible market – as it states elsewhere that the price to be used for measurement should be free from entity-specific factors.

Q11. *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.*

The Discussion Paper defines transaction costs as costs for which market participants would not be expected to be compensated. It concludes that transaction costs need to be expensed.

The treatment of transaction costs depends on the market which is used to examine the expected compensation for costs incurred. From an economic point of view this should be the market in which the entity intends to sell the assets (as a whole or as a part of a new product).

If an entity acts as dealer and buys/sells assets/liabilities at the same market (e.g. an exchange market), the entry and the exit market are identical. Such assets/liabilities are usually classified as trading and carried at fair value in subsequent measurement. In such circumstances transaction costs should be expensed[1].

Otherwise, if the assets purchased or liabilities issued are used in the production of goods or services, or are sold in another market (e.g. retail contra wholesale), the relevant market will be the exit market on which the company usually sells those products – which implies that the exit market is different from the entry market. As,

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[1] If an entity is carrying some financial instruments at fair value, transaction costs should be expensed at initial recognition. Otherwise at the next valuation date they would be expensed in any case as result of the revaluation to the actual fair value, which will not include transaction costs incurred.

in general, all costs borne by an entity are included in the price calculation, the price for the final product paid by the customer also covers transaction costs of obtaining the raw materials, or the cost of packaging and selling in smaller quantities. As a result, the entity is compensated for its transaction costs in the exit market.

To summarise: transaction costs should be expensed if the acquired assets or liabilities are sold in the same market as they are acquired. Otherwise, they should be recognized at initial recognition as a part of acquisition value. In addition, the treatment of transaction costs needs to be examined in the context of the effect on subsequent measurement. In other words, it is not merely an initial recognition issue.

Q19. *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.*

Portfolio Definition (Chapter V)

The Discussion Paper defines the concept of "portfolio" (see page 37, para 67 of the condensed version) as "*a group of similar assets or liabilities in which the individual items retain their identities*".

However, as different characteristics may be relevant for different purposes, the "portfolio" concept should not be defined in a way which is too narrow. The basic feature of a portfolio is that instruments within the portfolio share one or more distinct characteristics and that they are being managed together. The proposed definition, furthermore, ignores that a portfolio can comprise both assets and liabilities.

Bid-Ask Spread (Chapter V)

Bid-ask spreads introduce uncertainty in measurement when there is no actual transaction price available in an appropriate market.

Without an actual transaction, bid and ask prices narrow down to a range in which a transaction would be possible. Therefore, any value within this range (including the bid and ask prices themselves) may be a possible outcome for a market price.

Bid and ask prices show the amount at which a buyer/seller would pay/receive to enter into the transaction. They may differ from each other only by the transaction costs incurred by market participants.[2] Further differences may arise and widen the spread if market participants have uncertainties in estimating the value of the asset/liability from their own perspective.[3]

However, when measuring an asset or a liability at initial recognition, one may assume that there has been a transaction in which the entity purchased/incurred the assets/liabilities which are to be measured initially. As a price for such a transaction is available, buyer and seller have obviously agreed on one market price for at least this transaction. Therefore, the bid-ask spread which may still exist in this market is not relevant when initially measuring the purchased asset/incurred liability.

The Discussion Paper does not recognise that the consideration passing in a transaction should be presumed to be the very best evidence of Fair Value. Consideration of bid-ask spreads then relates to questions of subsequent measurement only.

[2] As observed on page 41, para 84 of the condensed version.
[3] As observed on page 41, para 84 of the condensed version.

Block discount or premium (Chapter V)

Considering a discount or premium raises the question which market – and, therefore which market price - is the most relevant when searching for the best estimate of fair value.

Assuming that the amount of assets/liabilities which have been acquired/incurred is equal to the amount that is considered to be initially measured, the amount paid/received in such a transaction already reflects any discount or premium (if the market allows any discount or premium). Other markets (and therefore other market prices) may differ from the market (or the market price) in which a transaction was actually executed. This difference may evidence the existence of a block discount or premium in certain markets. However, when measuring assets/liabilities at initial recognition it is appropriate to look at the market on which the assets/liabilities have been acquired/incurred.[4]

To summarise: the transaction price for the purchased/incurred quantity of assets/liabilities should be presumed to be an appropriate measurement basis at initial recognition. It reflects any effect that a large quantity might have on the price. When measuring at initial recognition, there is no room for any separate measure of block discount or premium.

The Discussion Paper fails to acknowledge that the transaction itself determines which is the most relevant market. Therefore the price for this transaction is the best estimate for fair value. This price already includes any block discount or premium. Considering a separate block discount or premium relates to questions on subsequent measurement only.[5]

[4] As observed on page 39, para 78 of the condensed version.

[5] The Main Discussion Paper appears to recognise this explicitly (see page 62, para. 171).

Demand Deposit Liabilities (Chapter V)

The Discussion Paper rightfully notes that the fair value of a portfolio of demand deposits differs from the sum of the principal amounts of the individual deposits. It argues that this difference stems from the fair value of benefits expected to be obtained from the customer relationship, which are intangibles.

We consider that the contract between demand deposit customers and their banks might have been oversimplified. The customers gain safe custody of their money, immediate access and an agreed level of service, usually including cheque books, internet access, automatic teller machines and convenient, manned branches. In return the bank may not pay interest equal to its funding cost in the interbank market on the balance. It is important that the value of these intangibles are not assimilated to the value of the related liabilities in the valuation process.