The South African Institute of Chartered Accountants

19 May 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

SAICA SUBMISSION ON MEASUREMENT BASES FOR FINANCIAL ACCOUNTING – MEASUREMENT ON INITIAL RECOGNITION

In response to your request for comments on the discussion paper *Measurement Bases for Financial Accounting – Measurement on Initial Recognition,* attached please find the comment letter prepared by the South African Institute of Chartered Accountants (SAICA). This submission includes comments from the Accounting Practices Committee (APC) of SAICA, the technical advisory body to the Accounting Practices Board (APB).

We would like to thank you for the opportunity to provide comments on this document. Please do not hesitate to contact me should you wish to discuss any of our comments.

Yours sincerely

Sue Ludolph
Project Director – Accounting

cc: International Accounting Standards Board (IASB)
Doug Brooking (Chairman of the Accounting Practices Board)
Prof Alex Watson (Chairman of the Accounting Practices Committee)

SAICA SUBMISSION ON MEASUREMENT BASES FOR FINANCIAL ACCOUNTING – MEASUREMENT ON INITIAL RECOGNITION

GENERAL COMMENTS

We appreciate the effort that has gone into the drafting of the discussion paper and have taken the time to review the discussion paper and respond to each of the questions raised. We do however have serious concerns about the purpose of the discussion paper and how it will fit into the current International Financial Reporting Standards (IFRSs) and current projects which the International Accounting Standards Board (IASB) have taking place, as well as concerns with the bias of the paper to assuming there are efficient and perfect markets for all transactions and hence that fair value is the appropriate measurement basis on initial recognition. The discussion paper contributes to the research material available on measurement, but in our opinion, some of the conclusions are too simplistic. Insufficient recognition is given to the views of preparers and users and the difficulties of implementation of the proposals, even though they may be academically sound. We have detailed below our overall concerns with the discussion paper, before answering the specific questions posed in the discussion paper.

Purpose of the discussion paper

It is unclear how the discussion paper will fit into the current body of IFRSs and whether it is intended that any standard arising therefrom would override the initial measurement requirements in each standard.

It is also not clear how this discussion paper will fit into the current agenda of the IASB and link into the results of the projects in progress, particularly the fair value measurement and the conceptual framework projects. Both of these projects will deal with many of the issues raised in the discussion paper and hence the outcome of these projects will have a significant impact on this discussion paper. Therefore, requiring commentators to give views on this discussion paper in isolation of the results of the other projects, is premature.

Narrow issue of initial measurement

The discussion paper addresses the narrow issue of measurement on initial recognition and ignores the issue of when to recognise the asset or liability. There are interdependencies on ‘when’ initial recognition should take place with that of ‘what’ should be recognised and ‘how’ it should be recognised. This is the logical progression to determining initial measurement. This discussion paper goes straight to the ‘how’ without addressing the other issues.

In addition, to consider initial recognition without considering subsequent measurement is again dealing with one piece at a time. This can result in a different answer if both are considered together. The discussion paper points this out, by stating that initial measurement decisions may preclude some subsequent measurement options.

It is therefore very difficult to comment on certain measurement aspects when the whole picture relating to measurement is not dealt with.

Fair value bias

The discussion paper is biased to fair value measurement on initial recognition, without consideration of the other IASB projects, which address the same issues. We are of the view that this is premature, given that the IASB is in the process of finalising an exposure draft on fair value measurement. Consideration would have to be given to the comments received on this exposure draft and the resulting standard on fair value measurement. Further, phase B of the conceptual framework project deals with elements of the financial standards – recognition and measurement attributes and phase C of the conceptual framework project deals with initial and subsequent measurement. The outcomes of all of the above project phases may arrive at a different solution to that reached on fair value in this discussion paper.

Whilst we are not opposed to using fair value measurement on initial recognition, we are concerned that the practical elements of measuring fair value have been understated. The discussion paper is very academic and assumes that efficient markets for all types of transactions generally exist in the world. This is currently unrealistic.

Insufficient research has been provided on the needs of users and investors with respect to fair value. The IASB is currently requesting the views of users on the usefulness of fair value measurement for financial instruments. The results of this should be considered and further research conducted on whether it would be useful to fair value all assets and liabilities on initial recognition and whether it is in fact possible.

Insufficient research

The discussion paper includes a long list of references, however it is unclear from reading the discussion paper whether any of the references have been used in getting to the conclusions. As noted above, it appears that insufficient research has been conducted with users to determine their views on the usefulness of fair value measurement on initial recognition. A basis for conclusions would assist to clarify this. As it currently stands, it appears as if the discussion paper is used to justify the authors' views that fair value is superior, as opposed to concluding after thorough research that fair value is the preferred measurement basis.

Manufactured products, self-constructed assets and internally generated assets

The discussion paper refers to measurement of assets on initial recognition and concludes that fair value should be used, provided it can be reliably measured. It omits to address the issue of how to measure manufactured products, self-constructed assets and internally generated assets. If fair value is used on initial recognition, this could lead to profit being recorded on day one, depending on the market used to fair value the assets. Whilst we appreciate that the discussion paper has referred to the various markets (paragraphs 74 – 82 of the condensed version and paragraphs 162 – 182 of the main discussion paper) we are of the view that insufficient research has been done in getting to the solution in the discussion paper in these paragraphs. See our answer to Question 10.

SPECIFIC COMMENTS

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.

Yes.

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 agree with the working terms, definitions and supporting interpretations of the identified measurement bases other than as indicated below.

The definition of current cost is "*The most economic cost of an asset or its equivalent productive capacity or service potential*." This definition is very wide, however is not based on accounting literature. All the other definitions are based on IASB texts and the IASB glossary. If the definition in the IASB glossary is used it should read *"The amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently"* or *"the undiscounted amount of cash or cash equivalents that would be required to settle an obligation currently"*. If this definition is considered deficient, we suggest the deficiencies are highlighted and the proposed amendments explained.

The definition for value in use refers to "*The present value of estimated future cashflows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life*." The definition is too simplistic and should further explore the entity specific and non-entity specific cashflows, which the FASB has done. The definition should also consider transaction specific and non-transaction specific cashflows. The IASB also uses an alternative definition in IAS 36 – *Impairment of Assets*, which may also need to be considered.

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.

The sources of differences quoted above are very broad and hence will probably cover most areas. However, in our view the conclusions reached within these areas are too simplistic and academic, by assuming that there are perfect markets and only one fair value for an asset or liability. Once again, it appears that conclusions have been reached without sufficient research. The issues of size of markets, different markets for the same products, different buying powers of purchasers, etc. have all been glossed over or not referred to. These can have a significant impact on the fair value.

For example, a wholesaler may determine fair value by reference to the price paid to the manufacturers. Sales are mainly to retailers, but may also be direct to the public. Retailers can purchase from the manufacturer or the wholesalers. What is fair value under these circumstances, the price charged by the manufacturer or the price charged by the wholesaler?

Question 4

The paper analyses 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)?

Given that we are unsure of the context of the discussion paper, we are of the view that the discussion paper is academic in assuming efficient markets. As there is no basis for conclusions reached, as noted in our General Comments above, we are unable to dispute the theories in the discussion paper.

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.

Yes, however it is often difficult to discern the one from the other as the two overlap.

We are concerned that paragraph 121 of the main discussion paper has a bias towards rejecting all management intentions when looking at measurement. However, when determining expected future cashflows these often include management intentions. Further, management intentions have an important role to play in financial reporting, especially with respect to disclosure. The intentions should be disclosed to enable investors and creditors to make their own judgements.

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.

The discussion paper has a bias towards market objectives based on the efficient market assumption referred to in our General Comments. The assumption is made without sufficient explanations that market objectives are more relevant, and ignores the reliability criterion.

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.

(a) No, we do not agree that that there can be only <u>one</u> market (fair) value for an asset or liability on a measurement date. IAS 39 – *Financial Instruments: Recognition and Measurement*, AG80 and AG81 acknowledges that there may be more than one fair value for an instrument or that the fair value is within a range and is still a reliable measurement.

(b) Differences between apparent market values for seemingly identical assets or liabilities on initial recognition may also be attributable to different valuation techniques and different assumptions used.

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.

Yes, in a perfect fair value world. This is an example of why the 'when', i.e. the timing of recognition, is important in coming to any conclusion.

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.

(a) IAS 39 deals with unit of account in its subsequent measurement principles. We are not sure whether unit of account can be considered for initial recognition without considering the subsequent measurement issues. The two are related. Again, without the basis for conclusions, it is difficult to determine what research has been done in arriving at this result. It appears that the solution reached is too simplistic. There is considerable literature addressing why units bought together are traded at different prices in a portfolio than if bought individually, and why a portfolio has a different value to the sum of the individual parts. As illustrated in the standard on business combinations, the fair value of individual assets and liabilities do not add up to the price paid.

(b) The discussion paper has not dealt with the aggregation of assets which have been componentised because of the need to depreciate the components over different useful lives, or with the implications for assets that are in the process of construction. Is the item marked to fair value during construction or only when available for use? Would a profit be recognised at that point?

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.

The discussion paper has ignored the fact that arbitrage exists and all the market theory regarding the behaviours of buyers and why they purchase in different markets. Whilst the discussion paper has considered some issues of entry and exit markets, wholesale and retail market and volume effects the behavioural aspects are ignored, for example buyers pay more for convenience and sometimes import products readily available in a local market. In our view, insufficient research has been conducted in this area.

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.

The discussion paper assumes perfect market conditions in all cases. However, the conclusion that transaction costs, as defined, are not part of the fair value of an asset or liability on initial recognition ignores this assumption. In a perfect market the fact that a buyer would be required to pay transaction costs, would result in the transaction cost being included in the fair value. Paragraph 86 of the condensed version defines transaction costs as "*directly attributable to the acquisition, issue or disposal of an asset or liability*…". Such costs should be included in the 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. However, the concept of relevance is dependent on the users' specific needs. IAS 39 explores this issue further, cross reference should be made to the conclusions therein.

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.

Yes, these are broad enough to capture all sources of limitations on measurement reliability.

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.

Although we do not dispute the theoretical argument, we do not believe the discussion paper has developed a strong enough case to come to the conclusion that fair value is the most relevant measure of assets and liabilities on initial recognition and should therefore be used when it can be estimated with acceptable reliability. The discussion paper assumes relevance is more important than reliability, which is not true in many cases, given the problems with reliable measurement for fair value. Input from all users of financial statements (eg. creditors), are needed before any conclusions can be made.

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.

(a) The current wording of the introduction to this question, read in conjunction with part (a) does not make sense to us. We do not understand the purpose of this question as it seems to ignore the fact that there are often very thinly traded markets when a single transaction exchange price would be accepted to be equal to fair value.

(b) In our view there is no fair value model which does not rely on entity-specific inputs and hence, we do not understand the context of this question. As stated previously, disclosure of those entity-specific assumptions are critical to enable users to make their own judgements.

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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.

The discussion paper appears biased towards the strengths of fair value and the weaknesses of historical cost which is difficult to support, lacking empirical evidence from users, investors and preparers.

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.

As indicated above, the discussion paper assumes fair value is the most appropriate measurement basis for initial recognition of assets and liabilities without indicating sufficient evidence of research and pre-empts the result of the fair value measurement project currently in progress. Therefore the comparison of other measurement bases to fair value is prejudiced by this basic assumption. It is current practice to disclose the measurement bases, which enables any user to make his/her own conclusions.

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.

As indicated above, the discussion paper assumes fair value is the most appropriate measurement basis for initial recognition of assets and liabilities without indicating sufficient evidence of research and pre-empts the result of the fair value measurement project currently in progress, which we understand will deal with the fair value hierarchy.

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.

We have no further comments.

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