Korea Accounting Institute KAI

Korea Accounting Standards Board KASB

Yonsei Severance B/D 24th Fl.
Chung-gu Namdaemunro 5-ga 84-11
Seoul 100-753, (SOUTH) KOREA

18 May 2006

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

Dear Sir or Madam:

The International Financial Reporting Standards Review Committee (IFRSRC) of the Korea Accounting Standards Board (KASB) has finalized its comments on IASB Discussion Paper, *Measurement Bases for Financial Accounting — Measurement on Initial Recognition*.
I would appreciate your including our comments in your summary of analysis.

The enclosed comments are those of the IFRSRC and do not represent official positions of the KASB. Official positions of the KASB are determined only after extensive due process and deliberation, to which this letter has not been subjected.

Please do not hesitate to contact us if you have any inquiries regarding our comments. You may direct your inquiries either to myself or to Mr. Kyoung-chun Yu (yukc007@kasb.or.kr), researcher of the KASB.

Yours sincerely,

Dr. Chung-woo Suh
Chairman, International Financial Reporting Standards Review Committee
Vice Chairman, Korea Accounting Standards Board

Cc: Hyo-ik Lee, Chairman of KASB
Sung-soo Kwon, Director of Research Department

Encl.

CWS/ykc

KASB IFRSRC Comments on IASB Discussion Paper
Measurement Bases for Financial Accounting
− Measurement on Initial Recognition

***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.*

In paragraph 73 of the long version of this discussion paper (hereinafter all paragraph references will be made to the long version of this paper), it was acknowledged that "[s]ome do not consider deprival value to be a separate measurement basis, but rather a decision rule for selecting between three of the above measurement bases (replacement cost, net realizable value, and value in use)". However, the paper decided to include deprival value on the list of identified possible measurement bases by arguing that "deprival value is based on an overarching theory of management behaviour that [...] adds an important dimension that integrates the three bases into a distinct measurement approach".

In line with such logic, we believe that recoverable amount is also "a distinct measurement approach" that "integrates' both net realizable value and value in use. To our regret, however, we were unable to find any explanation on why recoverable amount has been left out from the list. We would like to propose, therefore, to include recoverable amount on the list and to provide analysis on where it would stand on this paper's proposed measurement hierarchy on initial recognition. If after deliberation and analysis, the project team decides to exclude recoverable amount from the list, just as it is proposed now, the team should provide a clear explanation on why it decided to do so—just as it has done with the case of present value.

In addition, we note that present value is the only one that is followed by an explanation on why it has been left out from the list of identified possible measurement bases. However, in order for this discussion paper to be deemed as a comprehensive deliberation on all existing measurement bases, it is our belief that the paper must provide analysis on existing measurement bases—such as appraisal value, entity-specific value, etc—and explanations on why they have been excluded from the list of identified possible measurement bases.

***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)?*

We generally agree.

Minority opinion on Q2 and Q18:

In paragraph 93, the paper explains that "suggestions for replacing the term "fair value" and specifically incorporating the market value measurement objective within its definition have not been adopted in this paper" because "[i]t is presumed that the term and definition set out at paragraph 88 should be interpreted to embody the market value measurement objective".

Some interpret such explanation as acknowledgement that the paper views fair value as a comprehensive concept that incorporates all other measurement bases. That is, under this interpretation, historical cost would be deemed as the fair value as of the time of a transaction, while all other measurement bases such as current cost, fair market value, and entity-specific value are appropriate fair values when historical cost cannot be measured reliably.

In line with such comprehensive concept of fair value, some therefore propose to amend the proposed measurement hierarchy into a two-tier system:

Top Tier	Fair Value
Bottom Tier	The same Levels 1-4 of the discussion paper, whereby Level 1 is restated as fair market value—instead of "observable market value"

***Q3**. 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.

Yes, we agree.

***Q4**. 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.

Yes, we agree.

(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.*

In defining the term *market*, the paper defines *market participants* as "knowledgeable, willing, arm's length parties"—in effect specifying the three criteria (knowledgeable, willing, and arm's length) that must be met to qualify as market participants.

We note, however, that in paragraphs 7 and C23 of FASB Working Draft, *Fair Value Measurement*, issued in October 2005, there is a fourth criteria that must be met to qualify as market participants: *legal and financial ability to transact*.

We would like to propose the paper to adopt the fourth criteria—*ability to transact*—of the FASB Working Draft in defining both *market* and *market participants* as it is our belief (a) that the fourth criteria is needed to make the entire concept of the term market participants as unequivocal as possible and (b) that there simply is no need for any minor divergence regarding this issue between the IASB and FASB.

In addition, we would also like the paper to provide general guidance—similar to the *proposed measurement hierarchy* for estimating and substituting fair value—on determining the scope of market in practice. We believe that such guidance is necessary to minimize possible future controversy in practice with respect to the definition of market and any monetary amount asserted as fair value derived from that market.

(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)?*

Yes, we agree.

Q5. *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, we agree.

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.*

Yes, we agree.

Q7**. **(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.*

Our opinion is that there is only one market (fair) value on a measurement date usually for specifically customized assets or liabilities. Such assets or liabilities with specific characteristics are unique in a market and each has a specific market price of its own. However, for most other common assets or liabilities, our observation is that, most often than not, there are more than one market value due to imperfect market conditions. We do not operate in a perfect market and hence, market imperfections and inefficiencies such as information asymmetry will result in different market prices for identical assets or liabilities on a measurement date.

In line with such observation, we would like to propose that the paper (1) include an in-depth analysis on cases in which there are a multiple market values—such as different entry or exit prices—for an asset or liability and (2) provide clear guidance on a specific (entry or exit) price that should be favored over the other—such as the guidance provided by the

FASB in paragraph C19 of its Working Draft, *Fair Value Measurement*, issued in October 2005.

(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.

Yes, we agree.

Q8*.* *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, we agree.

Q9*.* *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.

Yes, we agree.

***Q10**. 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.*

Yes, we agree.

***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.*

Comment 1: *Information risk* is also a form of transaction cost. In other words, the risk of not being able to completely share information between market participants should be considered as an inseparable systematic risk. In recent studies it has been shown that information risk varies among different countries depending on the size of national economy, level of capital market development, degree to which stock market indices correlate with one another, differences in legal and other systematic infrastructures, etc. Hence, future standard-setting process should take into consideration the nature and extent of transaction costs incurred as a result of information risk and their potential effects and implications in practice.

Comment 2: The paper proposes that transaction costs should be included in fair value if they are recoverable and be expensed if they are not recoverable. However, if corporate insiders were to evaluate the recoverability of transaction costs, such evaluation would be inconsistent with the fair value measurement concept, which assumes that asset prices are determined (or estimated) in accordance with market expectations. This inconsistency may be understood from the information-risk perspective, which explains the inseparable systematic risk arising from private information that has not been completely shared between insiders and outsiders. Future standard-setting process should take into consideration the notion that the market will work to reflect in market prices information risk arising from the recoverability of transaction costs.

Comment 3: According to the paper's proposed accounting treatment of transaction costs in relation to their recoverability, an entity is required to recognize losses even at the very initial asset-recognition stage when no revenue related to the asset-acquisition has been realized. Although we generally agree with the overall conceptual analysis of the paper, we are nonetheless concerned that such drastic change in accounting treatment of transaction costs will bring about massive confusion in practice. We would like to urge strongly, therefore, that thorough empirical analysis on possible effects and burdens to all interested parties be carried out before any the paper's proposed accounting treatment of transaction costs is actually required to be implemented.

Q12. *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 generally agree. However, we would like the paper to provide (a) explicit criteria on how to determine the "acceptable level of reliability" in practice and (b) further clarification on whether such "acceptable level of reliability" is an absolute level deemed by the IASB as being reliable or a relative level that may differ among jurisdictions—for instance, it is our observation that what one would deem as an "acceptable level of reliability" in a developed country would be quite different from an "acceptable level of reliability" determined in a developing country.

Q13. *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, we agree.

Q14. *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 agree with the notion 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 are concerned—as it has already been commented in Q12 above—that the concept and eventual determination in practice of "acceptable level of reliability" would pose substantial threat to the issue of accounting consistency.

Under Levels 1 and 2 of this paper's proposed measurement hierarchy for estimating fair value, any practically feasible estimation would require either the existence of observable markets and prices determined in such markets or sophisticated valuations techniques that can be implemented in practice. In other words, any *reliable* estimation of fair value necessarily requires existence of highly developed accounting and financial infrastructure that would support its viability and credibility.

To our regret, however, it is our observation that there are only a handful of jurisdictions in the world—namely, the developed countries—that currently have such highly developed accounting and financial infrastructure. For all those other jurisdictions, including Korea, that do not currently have such supporting, core infrastructure, it would either be quite infeasible to estimate fair value in practice or be very costly to do so.

We believe that such an issue will undoubtedly bring about quite a number of different "acceptable levels of reliability" in estimating fair value around the world and, thus, result in a new round of inconsistency issues among different jurisdictions, which would in effect work to undermine overall user confidence.

Q15. *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 generally agree.

Minority opinion on Q15(a):

> Some belief that it would be too much of a burden in practice to require that "[a] single transaction exchange price should not be accepted to be equal to fair value unless there is persuasive evidence that it is". Instead, they would like to propose to revise the statement as follows: a single transaction exchange price *shall* be accepted to be equal to fair value unless there is persuasive evidence that it is *not*.

***Q16**. 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.

We generally agree. However, we have the following comment with respect to deprival value:

> Since net realizable value and value in use are both entity-specific values, they implicitly assume that the corporate management operates under rational decisions.

However, because both of the entity-specific values are subject to entity-specific insider information, information asymmetry between insiders and other market participants will necessarily result in different calculations of deprival value.

On the other hand, fair value measurement objective assumes an efficient market in which information asymmetry is not a major factor of consideration and, instead, fair value is considered to include insider information of the management. However, it would be both unrealistic and controversial to assume that the market has synthesized all available information in the determination of an asset's fair value. Thus, it is our opinion that further analysis be carried out on how to treat entity-specific information in determining fair value by each entity.

Furthermore, risks related to varying information in practice would differ depending on the unique market conditions of each jurisdiction. Hence, further study should be carried out into the viability of considering the world as a one complete market, when it is apparent that distinct prices are determined depending on each jurisdiction's market condidions.

***Q17**. 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.*

Yes, we agree.

***Q18**. 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 generally agree. However, please refer to Q2 for a minority opinion express that also relates to Q18.

***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.*

KASB IFRSRC Comments on IASB Discussion Paper
Measurement Bases for Financial Accounting
– Measurement on Initial Recognition

Comment 1: As it has been noted in paragraph 21 of this paper, we agree with the statement that "there is not a clean division between initial measurement and re-measurement". Among other aspects, we believe that consistency in application of a selected measurement base at initial recognition should be maintained at subsequent re-measurements. Hence, in carrying out the next stages of this entire project on measurement bases, we would like to urge strongly that the paper incorporate both initial recognition and re-measurement issues all at once and no longer try to make an unclear distinction between the two.

Comment 2: It is our observation that in the case of a self-constructed asset, for example, it is highly likely that (historical) costs incurred in the construction process would differ from the asset's fair value at initial recognition. Although it seems quite natural that accounting for such difference would be a major concern in practice, we anxiously note that the paper is silent on this issue. We would like to propose, therefore, that the paper (1) provide clear guidance on how to account for such difference between historical cost (or acquisition / transaction price) and fair value of an asset at initial recognition and (2) carry out an in-depth empirical analysis on the implications of such new accounting treatment in practice.

Comment 3: The traditional way of accounting for assets and liabilities is to recognize them at the fair value on acquisition date and no gains or losses resulting from the comparison from contractual date pricing are considered. In this paper, timing difference between contractual and acquisition date could lead to the recognition of losses and gains. This would result in a fundamental change in the concept of how assets and liabilities are being recognized and further analysis is also required to be performed for such a major change. Before finalizing this paper and moving on to next phase, the pervasive impacts on the current standards and the practical burdens should be analyzed.