bankenverband
BUNDESVERBAND DEUTSCHER BANKEN

By e-mail: dtweedie@iasb.org.uk

Sir David Tweedie
Chairman
International Accounting Standards Board
1th Floor, 30, Cannon Street
EC4M 6XH London
UNITED KINGDOM

Ref. H 3.9 - Bo/To
Contact Anke Borchardt
Tel. +49 30 16 63 22 40
Fax +49 30 16 63 22 99
E-mail anke.borchardt@bdb.de

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Discussion Paper: Measurement Bases for Financial Accounting - Measurement on Initial Recognition
Comments of the Association of German Banks

Dear Sir David,

Thank you for the opportunity to comment on the discussion paper *Measurement Bases for Financial Accounting - Measurement on Initial Recognition.* We would like to begin by making some general remarks, which are followed by our replies to some of the specific questions raised in the paper.

I. General remarks

Measurement issues are currently under increased discussion at the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) in the context of both the convergence programme and other ongoing projects such as the framework. The discussion paper prepared for the IASB by the Canadian Accounting Standards Board examines questions related to the measurement of assets and liabilities on initial recognition and analyses various possible measurement bases. This offers an opportunity for a broad debate on issues of measurement which we consider highly important as a basis for further work by the two standard setters and the development of future standards.

However, we have identified a number of fundamental weaknesses in the paper and are not in agreement with some of the major conclusions it has drawn.

In our view, the current focus of the standard-setting process should be on harmonisation of IFRS and US GAAP so as to lay the groundwork for mutual recognition of these two sets of standards as soon as possible. The discussion paper, however, goes far beyond the issue of convergence and marks a further step towards full fair value accounting. Yet it remains an open question whether there is any need at all for a new measurement approach and thus for changes to existing measurement principles. Furthermore, the paper is unable to deliver a conclusive argument that fair value measurement can best meet the overarching objective of decision usefulness – irrespective of the fact that there are also other views about the objective of accounting. Given that no observable market price exists for the vast majority of assets and liabilities, full fair value accounting raises a number of problems and unresolved questions to which, in our eyes, the discussion paper fails to provide a satisfactory response.

The paper has launched a keen debate on issues associated with measurement on initial recognition. This exchange of views is intended to help bring about consistency in measurement approaches and models between individual standards and the framework. In our opinion, this is a welcome and highly necessary objective. At the same time, we believe pertinent comments on the paper's conclusions regarding the appropriateness and superiority of certain measurement bases are impossible without a clear definition of what view of a company's financial performance and financial position its annual accounts are actually supposed to reflect. The IASB has always quoted "decision usefulness" as the primary objective of financial statements. Other parties have also mentioned "stewardship" and "accountability". These aspects are under examination in the IASB's current project to revise the framework. The outcome of the framework project therefore has direct implications for measurement issues and we believe the two areas cannot be looked at in isolation from one another. It is therefore essential, in our view, to begin with a thorough discussion of the overarching principles that make up the framework before addressing and reaching a conclusion on aspects related to measurement. Only when these foundations have been laid will it be appropriate to publish any further standards or exposure drafts in which measurement issues play a central role. We are thinking, for example, of accounting for business combinations, the fair value measurement guidance project and revenue recognition.

The discussion paper deals exclusively with measurement on initial recognition. We take the view that initial measurement also has far-reaching implications for re-measurement and that these two aspects cannot be examined in isolation from one another. The paper considers certain issues from the perspective of initial measurement which we believe would be better handled in an analysis of re-measurement (e.g. paras 110 and 179 of the condensed version).

The IASB has recently asserted repeatedly that future projects will help to streamline and reduce the complexity of financial reporting. We wonder whether a 144-page discussion paper containing numerous terms which are inconsistent or at odds with existing standards and exposure drafts can really contribute to a simplification or whether exactly the opposite will be achieved.

II. Replies to selected questions

Since we have a number of major fundamental criticisms of the discussion paper, we have focused in our replies on what we see as the most important questions.

1. (Q6):

Do you agree with the comparison of market and entity-specific measurement objectives 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?

The comparison of market versus entity-specific measurement leads to the conclusion that any information that is not market-specific and thus not accessible by all market participants is subjective and thus less important for users than that provided by market-specific measurement.

The discussion paper does not, however, make clear why market-specific models should be given preference over an entity-specific measurement approach. The argument that the former delivers more relevant information fails to convince. Discussions currently under way about management commentary (*Discussion Paper: Management Commentary*) and segment reporting (*Exposure Draft: Segment Reporting*) highlight the benefits of a "management approach". These two recent publications by the IASB stress that the management perspective delivers information which can greatly assist investors in making their investment decisions. Even in the context of full fair value accounting it is often merely implied that measurement will always be based on market values (and thus be reliable and objective). Since the majority of assets and liabilities have no observable market price, their fair value must be calculated on the basis of valuation models. Choosing a "suitable model" from all the models discussed in finance literature and setting 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 already represents a contradiction.

There are other contradictory statements, too. The discussion paper envisages, for example, 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. Elsewhere, however, it is stated that the price to be used for measurement should be free from entity-specific factors.

Another advantage of measurement based on market-specific calculation models and parameters is said to be that it is not influenced by how the asset or liability was acquired or incurred or by how an asset, for example, is used within the company. Yet it should be borne in mind that, in a going concern, an asset (or liability) is intended for use in the company. The total value of an entity cannot normally be calculated simply by adding together its individual assets since this takes no account of synergies within the company or by virtue of the company being embedded in a group.

One objective of accounting is to provide users with information which can enable them to draw conclusions about the company's potential to generate future cash flow. The decisive point in this context is the cash flow of the company as a whole, which, for the reasons outlined above, cannot – irrespective of the question of the feasibility of allocating individual cash flows to individual assets or liabilities – be calculated simply by adding them together.

<u>2. (Q 8):</u>

Do you agree that a promise to pay has the same fair value on initial recognition whether it is an asset or 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? If you do not agree, please explain the basis for your disagreement.

Under this approach own credit risk would also have to be taken into account when measuring liabilities. In our view, this would produce contradictory and economically unjustifiable results in the profit and loss account. A downgrading of a company's credit rating would increase the credit spread, which would in turn reduce the market value of its liabilities. This change would be recognised as income in the profit and loss account and lead to an absurd situation whereby a deterioration in a company's prospects would result in earnings being reported. Distortions of this kind are not intelligible to users and are incompatible, in our opinion, with the concept of decision usefulness.

3. (Q11):

Do you agree with the conclusion that transaction costs, as defined, are not part of the fair value of an asset or liability on initial recognition.

The discussion paper argues that transaction costs are not part of the fair value of an asset or liability because they are not recoverable. Transaction costs should therefore be recognised as an expense as soon as they are incurred and not, as at present, spread over the useful life or maturity of the asset or liability. This approach assumes an economy with perfect and complete markets in which no transaction costs are incurred. It does not reflect reality, where transaction costs can be quite significant. It is implicitly assumed, without any satisfactory explanation being provided, that immediate recognition as an expense of transaction or incidental acquisition costs is more objective than the use of an entity-specific fair value in which transactions costs are included. Immediate recognition as an expense would mean acquisitions were no longer neutral in their effects on earnings. What is more, this approach is at odds with the matching principle set out in the framework (F.95). In addition, it is not made clear exactly what costs "transaction costs" are intended to cover.

An assumption of this kind, which has such far-reaching implications not only for initial but also for re-measurement, cannot be made without first undertaking a detailed analysis of its effects. Furthermore, it is another illustration of the fact that initial measurement and re-measurement cannot be dealt with in isolation from one another. We believe a more detailed and differentiated approach is needed.

4. (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?

The paper's arguments in favour of full fair value accounting fail to convince. The long-standing criticisms of full fair value accounting apply here, too. Full fair value accounting assumes that the more closely information is based on the market, the more relevant and useful it will be in making investment decisions. This theory is based on the assumption of perfect and complete markets for goods and capital. In practice, however, it is extremely difficult to determine a fair value because the vast majority of assets and liabilities have no observable market price.

To overcome this problem, measurement models must be used. The choice and use of the parameters to be applied, however, are verifiable and objective only to a limited extent. On top of this, these valuation models reflect reality in a highly simplified and imperfect manner. This gives rise to various problems, such as financial statements losing objectivity, unrealised changes in present value being reported and increasing volatility in profit and loss. It is therefore open to question whether a preference for market value measurement should be justified by citing advantages which, in reality, only rarely exist.

True, the discussion paper admits that there are sometimes considerable uncertainties associated with its preferred method of measuring at fair value. Yet the authors believe there is nevertheless no reason to conclude that the resulting measurements will necessarily be unreliable and thus unsuitable. They argue that, to compensate, the measurement models and associated uncertainties should be explained in depth in the notes. This is not convincing. The relevance of a measurement associated with so many uncertainties and assumptions is more than questionable if it can only, if at all, be understood with the help of copious additional information. This would merely lead to a further inflation of information in the notes, which is totally at odds with the declared objective of concise and understandable financial statements.

In imperfect markets, measuring assets and liabilities at fair value on initial recognition makes it necessary, simply because of measurement uncertainties and market imperfections, to report day one expenses and profits in the profit and loss account. We wonder whether this is really conducive to supplying relevant information which will assist in making investment decisions.

5. (Q 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? If not, please explain why?

We fail to see the logic of this approach. If a fair value cannot be reliably estimated for certain assets or liabilities, there must be a reason. The reason may lie in the absence of liquid markets, for example. In such a case, fair value cannot be deemed an appropriate means of measuring these assets and/or liabilities. We do not understand why alternative measurement bases should be geared towards the objectives of fair value measurement in these circumstances nor what exactly this is supposed to mean.

III. Conclusion

It is not clear to us how this discussion paper is intended to fit into the IASB's current agenda. The paper focuses solely on the initial measurement of assets and liabilities in total isolation from the issue of re-measurement or of other fundamental IASB projects such as the framework. Yet it is essential to consider links to other ongoing projects and to deal with issues in a sensible order if a consistent set of rules is to be developed.

Nor do we agree with the paper's conclusion that fair value measurement of assets and liabilities is the most suitable model. The assumptions and inferences made in the paper often lack coherent justification. Since observable market prices exist, in reality, only in rare cases, the market view cannot always be used as the preferred measurement base. Focussing on market value measurement with full fair value accounting raises a number of questions and problems which seriously detract from the information value of financial statements.

For these reasons we consider the results of the discussion paper to have only limited suitability as a basis for the IASB's future work. We strongly urge the IASB to focus on what market participants see as priority tasks. These include, above all, the improvement of existing standards – particularly on accounting for financial instruments – and on further progress on the convergence of IFRS and US GAAP. Here, it is important that the IASB view the convergence process as a further harmonisation of both sets of standards, not as an opportunity to introduce fundamentally new accounting concepts.

Yours sincerely,

K. Burkhardt   Anke Borchardt

Katrin Burkhardt   Anke Borchardt