industrie-
holding
The Federation of
Swiss Direct Investors

Mr. Alan Teixeira
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October 28, 2005

Dear Mr Teixeira

Exposure Draft of Proposed Amendments to IFRS 3, Business Combinations

We very much welcome the opportunity to comment on the Board's proposals. Our comments have been prepared in conjunction with representatives from the major Swiss industrial and commercial multinational groups amongst our members.

1. General Comments

We continue to support convergence of IFRS and US-GAAP to permit a level playing-field in financial reporting. This is particularly necessary in reporting business combinations which, in the past, gave rise to major reconciling differences for dual-reporting groups. However, with the present IFRS 3, which has only just been implemented, convergence was already largely achieved in this area. Although published under the convergence banner, the proposed changes appear rather to target the introduction or extension of fundamental new conceptual bases which have not themselves been exposed to public debate and can by no means claim widespread acceptance among the primary players in financial reporting, the preparers and the users. There is as yet practically no support for the general adoption of fair values on the part of the former; and the AIMR's 2003 financial reporting survey only elicited explicit support for fair value from 3% of polled members, insofar as these can be taken as representative of users, and recent contacts with members of the user community have confirmed a lack of enthusiasm for what is seen as fixing something that is not broken.

Without a prior debate on this, and the other fundamental issues of the probability criterion for recognition and the full economic entity concept, with continuing contraventions of the existing Framework and with its constant apparent confusion of financial reporting with valuation, the IASB will find it difficult to gain wholehearted acceptance of its proposals among key constituents. The debate must take place before any specific proposals like the present ones can be properly

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considered. We are therefore unable to support the current proposals for amending IFRS 3. Furthermore, we very much share the doubts expressed by the five dissenting members of the Board as expressed in the „Alternative Views“.

Some of our members see some practical benefits in some of the specific proposals. The accounting for step acquisitions and for small ownership changes with no change in control would be simplified, while the suggestion on contingent consideration would avoid adjustments to goodwill possibly dragging on over an indefinite period. However, in our opinion, these are marginal, and the Board has not demonstrated any other material benefits and advantages from the proposed changes. On the other hand, we see significant overall disadvantages, which lead us to reject the proposals. As well as having the objections on conceptual aspects mentioned above, we cannot subscribe to the Board’s assertions of increased transparency; indeed, the reporting of hypothetical values in the financial statements, rather than actual transaction values, will make it even more difficult for users to derive data to help them form a judgment on sustainable future cash flows, which are key to their considerations.

Moreover, the proposals would result in many cases in a significant reduction in the reliability of reported financial information, especially where values are determined in situations where no market information is available (e.g. acquisition of control of private companies). We do not perceive any increase in the relevance of the reported financial information as a consequence of the proposals to outweigh these disadvantages. Thus, there would be no significant enhancement of relevance but an unacceptable sacrifice in reliability, to which IASB unfortunately seems to be according less weight than relevance in contrast to the Framework’s equal weighting. These views are expanded in our responses to your specific questions below.

2. Specific Questions

Question 1

Are the objective and the definition of a business combination appropriate for accounting for all business combinations? If not, for which business combinations are they not appropriate, why would you make an exception, and what alternative do you suggest?

For the reasons given in our general remarks above and under question 3 below, we are unable to support the objective as stated, because of the “acquisition method” described therein. We see no significant benefits from changing from the current “purchase method” based on cost.

Subject to the scope exceptions for joint ventures and combinations of entities under common control, we can agree with the proposed definition of a business combination in the sense of acquisitions. However, we believe that it still leaves a problem for those situations in which an acquirer cannot be identified. In practice there can be true mergers - particularly in the area of combinations involving two or more mutual entities or combinations achieved by contract alone - and we believe that, in those cases, the application of the acquisition method, involving the identification of the acquirer in all cases, will not reflect economic reality. The wording of the definition of “business combinations” appears to scope out such transactions: this leaves them unregulated specifically under IFRS. We believe that this situation would need to be clarified.

Question 2

Are the definition of a business and the additional guidance appropriate and sufficient for determining whether the assets acquired and the liabilities assumed constitute a business? If not, how would you propose to modify or clarify the definition or additional guidance?

We could accept the definition and the additional guidance.

Question 3

In a business combination in which the acquirer holds less than 100 per cent of the equity interests of the acquiree at the acquisition date, is it appropriate to recognise 100 per cent of the acquisition-date fair value of the acquiree, including 100 per cent of the values of identifiable assets acquired, liabilities assumed and goodwill, which would include the goodwill attributable to the non-controlling interest? If not, what alternative do you propose and why?

Apart from our general objections given on page 1 of this letter, we believe that the proposed approach is not appropriate for the reasons set out by the dissenting Board members in Proposed Amendments to IFRS 3, AV2-7. In our view, the treatment of acquisitions should continue to be based on the parent-oriented, cost-based approach of the current IFRS 3.

It is worthwhile to add that we think it wrong to move away from accounting for actual transactions which have taken place and the generally clear “real-money” costs involved to accounting for hypothetical values based on estimates subject to a potentially wide range of outcomes, especially where no specific market data are available as in the case of acquisitions of control of privately owned businesses. Neither can we identify any concrete benefits in doing so. While full (100%) fair values for individual identifiable acquired assets and liabilities are more meaningful (as under the present IFRS 3) and thus aid transparency, goodwill is not like any other asset. Users of financial statements do not generally think it has the same level of information content as the other asset numbers, and accounting treatments that produce very useful information when applied to other assets do not necessarily generate any benefit when applied to goodwill, which is – and should remain – purely a difference arising out of the particular transaction. It should be borne in mind that, since there would be exceptions to fair value as a basis for the identifiable assets and liabilities (e.g. deferred tax), goodwill would not in any case be a “clean” fair value but would include differences from fair value on such exceptional items. It is not, and under the proposals would still not be, a very useful number. For that reason it is particularly important in this case to consider the costs and benefits of what is being proposed, and we are not convinced that the Board has identified worthwhile benefits arising from the proposals. Users would suffer instead the increased ‘softness’ of the numbers reported under the proposals.

In connection with the proposals on IAS 27 also, we prefer the present approach to the full economic entity concept. Users of a group’s financial statements are interested in the earnings and net assets attributable to the parent company’s shareholders: minority shareholders will refer to the financial statements of the company in which they have their interest for information.

Finally, we are concerned that the proposals would substantially increase the complexity of tracking and calculating minority interests. With the proposed goodwill allocation method, the percentage of ownership would no longer be an indicator which can be used directly. Following example 4 in A62 and A63, we easily arrive at strange situations with only slight adjustment to the assumptions. For example, if AC pays a “fair” price of CU 170 instead of CU 160 (reflecting synergies etc.) AC's "real" goodwill of CU 50 would be capped at CU 45, which does not properly reflect what has actually been paid. The mechanics of the consolidation in such situations are also not quite clear to us. Taking the "fair" price as CU 170 in example 4 and assuming push-down of the acquisition accounting and no impairment problem, we see the situation as follows:

	AC	TC	Aggregated	Consol.adj.	Consolidated
Goodwill		45	45		45
Identified assets/liabilities		150	150		150
Investment	170		170	-170	0
Equity:					
- controlling interest	170	195	365	-200	165
- non-controlling interest*				30	30

19 May 2006

CL 67

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Dear Sir,

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

The Federation of Swiss Industrial Holding Companies (Industrie-Holding) represents most of the larger industrial groups with headquarters in Switzerland, the majority of which are multinationals and have been preparing their consolidated financial statements according to IAS/IFRS for well over a decade. This comment letter on your Discussion Paper (DP) has been prepared in conjunction with the largest of those member companies.

Before discussing the detailed points made in the paper, we would like to make some general comments. May we emphasise that our comments are in any case made from the viewpoint of an industrial entity: much of the DP seems to have the perspective of financial institutions, for whom fair values may – or may not – be "just a few keystrokes away" in more instances than they are for industrial assets and liabilities. Also, many of our comments relate to the application of the fair value measurement basis in general, not just to its use on initial recognition, as we do not believe it to be cogent to consider measurement on initial recognition separately from subsequent measurement. We concentrate on the decision-usefulness aspects of financial reporting as this is the focus of the DP, but we insist that the stewardship/accountability aspects of financial reporting warrant much deeper reflection than the DP has had the time and space to give them and that such reflection would result in less support for the fair value conclusions arrived at.

We have looked forward for some time to a general debate on financial reporting but are somewhat disappointed by this start. A key weakness of the DP is that the discussion seems to take place in a theoretical vacuum, rather than establishing first how the decision usefulness objective of financial reporting mentioned in the paper should be translated into arguments for changing the way assets and liabilities are measured today. Financial reporting is essentially a practical mechanism for communication between preparers and users of financial statements. (For the latter we may focus on financial analysts, investors or providers of capital, as the "Framework" does). It does not have a raison d'être outside of serving that purpose, and it needs to be considered in terms of its fulfilling that purpose, not against more general, philosophical criteria (i.e. no "art for art's sake").

The implication of the DP that fundamental changes to financial reporting are required is not confirmed by the requests that preparers receive in their regular contacts with analysts. The latter ask rather for more information about markets and competitive positions, performance of business segments, innovation, prospects for new products and services, and the strategic options open to the company. A few specific areas for improvement in financial reporting do emerge from these contacts: for instance, current pensions accounting is frequently a target for complaint. However, such areas for improvement appear to be far more limited than requiring fundamental changes to the accounting model – especially after the advances which preparers have made in recent years in transparency and in implementing new and revised standards. It is by no means clear to us that the calls for fundamental changes from some groups of users are at all representative of users at large rather than of a small if enthusiastic minority. In short, there appear to us to be as yet no reliable indications among the primary parties involved in financial reporting – preparers and users – of any need or desire for a fundamental change in the accounting model.

Nevertheless, a debate would indeed be very welcome on financial reporting from the practical viewpoint of what preparers and users wish the financial statements to show differently so that they are useful for economic decision-making and for stewardship purposes in order to clearly confirm the primary parties' positions. The question of the measurement basis – whether on initial recognition or subsequently – could then follow on logically from consensus related to which assets and liabilities should be shown differently in the balance sheet. This approach would also eliminate the problem that measurement on initial recognition cannot be sensibly divorced from subsequent measurement: the two are logically closely connected. We believe that it would be more difficult than the paper suggests to revise conclusions on measurement on initial recognition in the light of later discussions on subsequent measurement at a later stage of this project.

Among the many unsupported assertions in the DP is that fair values are more useful for economic decision-making. Users want reliable information to enable them to make forecast of future long-term cash flows as the basis for their valuation of the entity. While market *exit* values may be interesting if the entity is planning to sell its assets and settle its liabilities shortly after the balance sheet date, it is by no means clear to us – or to the analysts with whom we have talked – how such values would be of use in general in doing the valuations. Indeed, there is considerably more support for having reliable historical information on the actual, transaction-based historical-cost results with which the analysts can work up their cash flow forecasts. Similarly, the DP offers neither theoretical arguments nor empirical support that would justify the implicitly assumed relevance of fair values of individual assets for deriving the value of companies. It is questioned whether the value of the entity can be readily derived from the summation of individual assets and liabilities. As we understand it, analysts use estimates of future (free) cash flows from continuing business as a basis for their valuation of companies. These cash flows are projected on the basis of analyses of historical, actual cash flows of companies and/or individual business segments. This approach is also applied internally by companies for the evaluation of investment and acquisition opportunities. From this standpoint the DP appears to fall into the trap of assuming that the value of the entity as a whole can be derived from the sum of the values of its assets and liabilities.

Equally, it is quite unclear from the DP how market values rather than entity-specific values could be used by – and be more useful for – analysts in forecasting future cash flows. Today's fair value of a chemical production plant which is going to be used for manufacturing active pharmaceutical substances for the next 20 years is not necessarily closely connected with the entity's future cash flows and therefore its total value.

The thrust of the DP and of the implied general application of a fair value measurement basis is somewhat disturbing for a further reason. They would move us further towards a purely monetary presentation of the business (change in values of net assets, a "black box") and away from a presentation of the business as a real process of creating new real products by the use of real resources. This is the key to the traditional income statement, which shows the actual realised value of resources created (sales) with the value of the resources consumed in doing so, reflected at the amounts actually invested to acquire them. This idea of the successful (or otherwise!) real economic process is the crux of business which theoretical valuations obscure. Most grass-roots analysts understand that this must be their focus: at analysts' conferences managements primarily face questions about the operating profit, the products-in-development pipeline, sales prospects for key products, trends in cost development, etc. and seldom – if ever – about unrealised gains and losses on available-for-sale investments.

The DP makes some fairly bold assumptions about the possibilities of taking quantitatively into account the effects of inefficiencies and other factors which make markets less than perfectly efficient. What may be basically tenable for some commodity markets is inapplicable to far more other markets than the DP suggests. Observable evidence does not support the view that a single fair value is generally readily derivable, and where management judgment has to be applied in deriving such a value the neutrality of the financial reporting is potentially at risk. Many of the arguments adduced in favour of the fair value measurement basis do not apply if there is no efficient market. Also, it is difficult to understand the conclusion that fair value can be a relevant measurement basis where no market exchanges take place.

The difficulties of putting the favoured fair value measurement basis into practice are substantially understated in the DP. Fair-valuing investments in frequently traded equity securities "a few keystrokes away" on the Reuters or Bloomberg screen is a very different matter from fair-valuing a complex, 12-year old chemical production plant. Members who had first-hand experience of applying current-cost accounting in past years would expect that the real, on-going costs of doing such valuations to be substantial for non-financial, non-traded assets and liabilities and express difficulty in identifying any tangible economic benefits from them. While we acknowledge that the DP does not advocate widespread use of current cost accounting, that experience is relevant because fair value measurement could in our view prove an equally difficult and costly process to implement for some assets and liabilities. Jurisdictions with an endorsement process could well have difficulty in accepting such appreciable extra costs as being in the public interest, especially as the primary parties involved are unlikely to support it and it is not at all clear who would actually want such a theoretical approach to financial reporting. Even many bankers are expressing considerable doubts on the usefulness of fair value information already received. Given the level of transparency already achieved in financial reporting, one could even imagine that the oft cited reduction in costs of capital from applying

IFRS might turn into an increase though the reduced understandability and reliability of the information reported more extensively on a fair-value basis.

Finally, we need to devote a few words to considering the “post-Enron” financial markets. All parties involved express the need to improve the credibility of financial statements damaged by the various “accounting scandals”. We believe that applying more extensively a fair value measurement basis in financial reporting would in fact have the opposite effect as it would move us away from showing real transaction amounts to hypothetical, in many cases scarcely verifiable amounts, which could undergo dramatic and rapid changes during periods of high market volatility. Such amounts would not necessarily be more objective than currently accepted measurements, because some degree of management judgement will be required to estimate fair value in all cases where no observable market price exists for an asset or liability. Even the consideration in the DP on faithful representation strikes us in this sense as somewhat off-track: we would argue that showing a chemical production plant which has just been completed after a 3-year construction period in the balance sheet at an amount which a hypothetical buyer and seller – if they could be found and if all of the entity-specific factors could have been eliminated – would have been willing to exchange if a transaction had theoretically taken place, would represent less faithfully the reality of the asset than the accumulated costs incurred in the construction.
We thank you for your attention to the above.

Yours sincerely

FEDERATION OF
SWISS INDUSTRIAL HOLDING COMPANIES

P. Baumgartner J. Atteslander

Dr. Peter Baumgartner	Dr. Jan Atteslander
Chairman Executive Committee	Member Executive Committee

cc - IH Committee
- IH Expert Group Accounting and Reporting

APPENDIX

This appendix contains our detailed comments on the paper.

General comments

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. 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, that is, on user needs. This is consistent with the tentative decisions taken by the IASB and FASB in their Framework project. However, decisions about measurement bases have as great an effect on the stewardship and accountability objective of financial statements as they do on the decision-usefulness objective. Management and shareholders have a stewardship 'contract', and financial statements have always been one main tool by which management performance has been assessed. The measurement bases used in financial statements effectively determine what management is accountable for in respect of the items reported in financial statements. Changing the required measurement bases of assets and liabilities through issuing accounting standards effectively changes the terms of the contract between management and shareholders and therefore the role which management is expected to perform. In our opinion, the paper needs to be even more explicit about what the authors assume management's role to be and how the proposed measurement changes are underpinned by that assumption.

- 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.

***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 this list is sufficiently comprehensive, and that, for completeness, each of these bases should be considered for both assets and liabilities.

However, we would emphasise that accounting for a transaction necessarily involves recording its amount. In most transactions which directly cause initial recognition of an asset or a liability, the transaction price gives a value which can be clearly and unambiguously identified with that asset or liability (of course, there are exceptions and we comment on these below). That historical cost basis necessarily has to be recorded. Requiring the asset or liability to be measured using any alternative basis conceptually implies re-measurement of the asset from its existing historical cost. Recoverable amount measurement is always the second step in a two-step process. For this reason, except in specific situations such as a business combination, or a multiple-element transaction exchanging a group of assets and/or liabilities, in which there is no separately identifiable cost for the individual items acquired, we would argue that these bases are outside the scope of initial recognition.

We recognize that the accounting double entry for most asset acquisition transactions recognizes both the acquired asset and the liability incurred to acquire it, and therefore it would seem logical to consider the same list of initial measurement bases for both assets and liabilities. However, we agree that the “liability equivalent” of net realizable value, value in use or deprival value, as defined in paragraphs 371, 384 and 400-401 of the paper respectively, should be considered as possible initial measurement bases where a liability is recognized but there is no corresponding asset to recognize.

***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 definitions given in the paper for each of the identified measurement bases.

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.

In our view, there is a fundamental difference between historical cost on the one hand, and the rest of the identified bases on the other, which relates to the overall purpose of financial reporting, society's definition of wealth and the role of entity management. Historical cost measurement records merely how the funding obtained by the entity has been used so that the entity's owner(s) can see what has happened to that funding. This allows owner(s) to hold management accountable only for their direct actions in carrying (or failing to carry) out transactions, some of which result in recognition of assets and liabilities. The other measurement bases also attempt to assess the economic value of the assets and liabilities at the measurement date. This allows owner(s) to hold management accountable for other changes in economic value, whether or not these have resulted from factors within management's direct control. In our opinion, much of the current debate on accounting measurement arises from differing expectations of management's role. While this is clearly linked to "market versus entity-specific measurement objectives", it also raises broader issues.

We agree that the 'value-affecting properties and market sources' discussed in the paper —the unit of account, the existence of different markets, information asymmetry, bid-ask spreads and transaction costs, and market accessibility and related issues—and differences between market-based measures and entity-specific measures - should be taken into account in the measurement debate. However, many of the factors analysed seem not to have been fully taken into account in the paper's conclusions.

Paragraph 135 states that an a priori expectation is that there would be only one fair value for an item on measurement date. It is clear from the paper (see paragraph 137 for example) that the authors have not been able to reconcile the view that there is only one fair value with the observable evidence.

The discussion of transaction costs in paragraphs 193 to 200 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, because it may be unclear from current market conditions what costs are recoverable.

For example:

- a re-seller or broker/dealer may be able to recover its transaction costs from the third parties with which it transacts, whereas those third parties may be unable to recover those very same costs as passed on to them by the re-seller.

- It may be unclear whether interest expense incurred during a particular period of an asset's construction is recoverable from the buyer of the asset. In the long term the asset supplier must recover these costs in order to remain a going concern, but during depressed market conditions these costs might be irrecoverable.

- Situations where the vendor pays some or all of the buyer's transaction costs, builds them into the sale price and issues a one-line invoice to the buyer, would be very difficult to identify unless fair value is measurable precisely. This could result in inconsistent accounting treatment compared with more straightforward situations in which buyer transaction costs are clearly identifiable from invoice documents.

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.

We agree that the definition of the market value measurement objective is reasonable.

(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.

A market exists wherever there is a commercial exchange of assets or services, and the word should be used generically with that meaning. We agree that a market must have many of the attributes mentioned in the definition - *A body of knowledgeable, willing, arm's length parties carrying out sufficiently extensive exchange transactions in an asset or liability* - to be considered as a possible source for reliable fair value measurement of assets and liabilities which are not acquired or incurred in that market. We are not sure whether adding the words *"to achieve its equilibrium price"* is essential because this is primarily a theoretical concept and we believe that practical acceptance of a pricing convention by the "body of parties" as a whole is more important. We are unhappy that this definition in the paper is used to suggest that actual transaction prices cannot be assumed to represent fair value (paragraphs 243 to 252).

(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)?

We agree with the definition in the paper of the market value measurement objective, though not with the paper's conclusions on its preferability over the entity-specific measurement objective.

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 agree with the way paragraphs 112 - 121 characterise entity-specific measures and their relationship to management intentions.

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.*

With regard to the comparison of market and entity-specific measurement objectives, we disagree with the analysis in the paper of the comparability criterion, which states that one difficulty with entity specific measurements is their variability over time. In our view, the opposite is true. Entity specific measurements are more constant for the reporting entity over time than market related measurements. For example, under market related measurement, the initial measurement of two identical assets with significant order lead times, acquired in the same fixed price contract, could differ if they were delivered on different dates, even if they are put into use on the same date. Unless subsequent accounting for the items was based on a full fair value re-measurement model, this difference could be perpetuated over the entire period the entity owned the assets. We would argue that that difference does not represent economic reality. Under entity-specific measurement objectives, the items would be recorded at the same value, initially because the fixed contract price would be used, and probably also subsequently, because under most measures of their economic value to the entity, the value of both would likely remain the same. We also disagree that differences between the reporting entity's measurements and the entity specific measurements of other entities necessarily make comparability more difficult. If they reflect real economic differences between entities, the ability of a potential investor to compare and contrast different entities is enhanced, because financial reporting makes those differences more apparent. That information is useful for investment decisions.

We disagree with the conclusion in paragraph 128 that the market value measurement objective is always superior in principle to entity specific measurement objectives. The main argument which the paper advances for this appears to be that there will be greater comparability over time and between entities. For the reasons we mentioned above, we disagree with that argument. There is clear empirical evidence that an entity's market capitalization is influenced by market assessments of the quality of the entity's management. If management's skill is relevant to valuing the entity as a whole, it seems wrong to disregard management's insight into asset and liability values, as represented by the costs management decided to incur for them, when recording their initial accounting measurement. If two different entities purchase an identical asset for different transaction prices, for example because of their entity specific advantages and disadvantages relative to the market, a market value measurement objective would result in the entities recording the asset at the same amount, assuming that market value could be reliably measured. At least one, and perhaps both entities would show a 'day 1 profit or loss'. An entity specific measurement objective would result in each entity initially recording the asset at its transaction price. We accept that the market value objective could be considered more informative about the asset itself and the entities' relative advantages in the asset acquisition process, although it might be difficult in some situations to identify the amount to be recorded as the market value. However, financial statements have to give an overall view of the entity's financial position and performance. We would argue in this context that the entity-specific measurements have the conceptual advantage of having more ongoing relevance to the entities as they use their assets in future periods - possibly in different ways - and the practical advantage of being simpler to record as initial measurements - because the transaction itself contains all the information required to record them.

In our view, market related measurement objectives are more relevant to assets and liabilities which have no unique entity-specific features and whose economic value to the entity is not affected by management actions or intentions. Quoted financial instruments, including derivatives, are an example. Entity specific measurement objectives are more relevant to assets and liabilities which are unique to the entity or whose economic value to the entity is dependent on management's actions. Specialized non-current assets and long-term provisions are examples. The greater usefulness of entity specific measurements of these types of assets and liabilities in valuing the entity which owns them was illustrated recently in relation to property held by retail businesses when, as part of its 2006 Budget proposals, the UK government announced details of the proposed advantageous tax regime for Real Estate Investment Trusts (REITs). Share prices of retailers rose significantly on the day of the Budget announcement, apparently based on market expectations that cash flows to shareholders from these businesses could be increased by putting their shops into a REIT structure. Within days, these share price gains had completely evaporated as financial markets realized that the continuing cash flows from existing business use of the shops remained relevant while property market values were irrelevant; the enhanced ability to realize higher market values could be achieved only if the retailers disposed of the shops or entered into sale and leaseback arrangements with third parties, both of which would reduce future core business cash flows and therefore entity valuations.

Paragraph 129 acknowledges that entity-specific measurements should be reported but states that *"such entity-specific information is more appropriately the subject of forecasts or supplementary disclosures, rather than being the basis for measuring assets and liabilities on initial recognition for external financial reporting purposes."* However, existing accounting frameworks emphasise that omitting relevant items from an entity's balance sheet is not rectified by disclosure of the items omitted. For this reason, entity-specific measurements deserve more than simply disclosure.

We accept that management's assumptions, expectations and intentions change over time even within the same management team in the same entity; that they are likely to change when new entity management is appointed; and that they are likely to differ even between entities which compete directly in the same markets. We do not believe that fact automatically makes financial statements less comparable if they take those differences into account in asset and liability measurement, because these are part of the genuine differences between entities which any investor evaluates. We accept the point made in the paper that the understandability and comparability of entity-specific measurements in these circumstances depends heavily on financial reporting disclosures about the entity's strengths and weaknesses relative to the market and about management's assumptions, expectations and intentions. Existing financial reporting requirements already include disclosures about management's critical accounting policies and assumptions.

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.

If "measurement date" is understood as one entire day, we do not agree literally with this conclusion, because quoted prices in active financial markets change during the course of each day. However, in our view, it may be possible to measure a unique fair value for an asset or liability in those markets on a given measurement date reliably, by reference to accepted pricing conventions such as mid-market closing prices. In other, less obliging markets, in our view there could be more than one market (fair) value for an asset or liability on a given measurement date because of information asymmetry. We agree with the paper's conclusion that the relevant market for initial measurement is the market in which the asset is acquired or the liability incurred. This will normally result in measuring the item at its historical cost. It may also theoretically allow an unique fair value to be measured reliably even if some assets or liabilities do have different fair values in different markets, although there may be significant practical difficulties.

(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 based on inefficient markets.

The paper itself states (in paragraph 136 of the long version) that the proposal referred to in (b) is not correct.

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 agree that if promises to pay can be and are exchanged, their fair value in a given market on a given date must be the same for the current holder, other potential holders and the issuer, because the definition of fair value implies a single agreed exchange price. We accept that in practice, in active financial markets where promises to pay are exchanged for cash, assessments of credit risk do affect their fair value, and the consideration exchanged for them, at their issuance date and subsequently. We agree that an entity issuing such a promise in these markets should reflect this in its initial measurement, but not in its subsequent measurement (unless the entity is no longer a going concern). In business to business or consumer markets where short term promises to pay are exchanged for goods or services, we see little evidence that credit risk directly affects fair value, although it does affect willingness to transact if the credit risk of one party is high.

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.

We agree that the appropriate individual item or portfolio unit of account on initial recognition is generally – though certainly not always - the unit of account in which the reporting entity has acquired the asset or incurred the liability. One exception would be the purchase of plant and equipment which is sold by the vendor as a single item at a single price. Existing accounting standards recognise that it may be necessary to record components of the equipment as separate assets if they have a useful life which is shorter than that of the item as a whole. The paper makes this point with reference to proposal 9 (b) – aggregation. We would argue that if a component of a larger asset can be separately removed from the asset and replaced, it has not lost its separate identity. We would not support setting the unit of account for aggregated non-current assets at the level of a cash generating unit as defined, for example, in IAS 36, *Impairment of Assets.*

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 agree that if an entity acquires or creates an asset or incurs a liability in an exchange transaction in a market, that market would be the best source for the measurement amount of the asset or liability on initial recognition, assuming the market value measurement objective. As we observed in our answer to question 7 (a) above, this principle will also generally lead to assets and liabilities being measured at their historical cost.

When assets are acquired and liabilities incurred in business combinations or multiple-element transactions which exchange groups of assets and liabilities, measurement should be based on exchange transactions in markets in which the entity normally separately acquires the assets or the inputs used to create the assets, or in which it normally separately incurs the liabilities, if such markets exist. We do not support using the markets in which the items are normally sold as suggested in paragraph 179, because that leads to inconsistent measurement of items acquired in transactions with different structures – a recognized problem in modern accounting.

In our view, it is rare for assets which are not normally acquired in or created through measurable exchange transactions to meet recognition criteria. For this reason we express no view on their measurement.

The measurement of liabilities which are not normally incurred in exchange transactions, or indeed exchanged at all outside the specific situation of a business combination, such as taxes, long term environmental liabilities and legal claims, depend on whether the entity can control how it extinguishes the liability. If the entity is legally or contractually required to settle a liability in a certain way, its initial measurement should be based on that requirement. If the entity has a choice of settlement methods, initial measurement should assume economically rational actions on the entity's part i.e. measurement based on the method which gives the lowest net cost of settlement, taking into account any changes which the settlement would cause in any other related economic benefits flowing to or from the entity. These principles may also apply to some liabilities which are incurred in exchange transactions, such as long term employee benefits.

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.*

We commented in our response to question 3 on the practical difficulty of distinguishing between costs that are recoverable in the market place and other costs. We would argue that any cost which contributes to an asset's functional performance, to its readiness for use, or to acquiring the right to use the asset in a particular location (such as customs duty payable when the asset is imported into the country where it will be used) is part of the asset and therefore of its initial measurement, if recognition criteria have been met. Other costs of the exchange transactions in which the asset is acquired are likely to be payments for services which, while directly linked to the acquisition of the asset, are separate from it. The issue is therefore whether those services meet the definition of an asset in their own right. If they do not, we would agree they should be expensed as incurred. The above comments are again based on the assumption of the market value measurement objective, to which we do not subscribe. If entity specific objectives are followed, any cost which specifically relates to the purchase or creation of an asset is included in its initial measurement.

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 that the most relevant measurement basis should be used if its reliability is acceptable. Our views on which measurement bases are relevant however differ from the views expressed in the paper. Please see our answer to questions 6 above and 14 below for our views on relevance.

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. We accept that determining what is sufficiently reliable will always involve judgement, but the exercise of this judgement should not be arbitrary and this issue requires further analysis.

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 accept the concept of a most relevant measure of “assets and liabilities” in general. In our view, the relevance of a measurement basis for an asset or liability depends on the nature of the item being measured, and on entity specific considerations. For example, if an entity did not incur and will not settle a liability in an exchange transaction, fair value would not be a relevant basis for measuring the liability in financial statements, even if users were interested to know the fair value and it could be reliably measured, because the fair value of that liability would not have any predictive value for the entity’s future financial position. The difference between fair value and entity specific value would represent, at most, a potential opportunity cost.

The paper has evaluated measurement bases other than fair value primarily in terms of their ability to represent fair value. This follows from the paper’s acceptance of the market value measurement objective. In our view, this is not appropriate and the alternative bases should be assessed on criteria independent from fair value, such as usefulness and predictive value.

We would argue that historical cost and fair value on initial recognition are the same in most exchange transactions in most economies, and can therefore be assumed to be the same for assets which are acquired and liabilities which are incurred in such transactions, unless there is clear evidence to the contrary. We accept that some exchange transactions are not priced at fair value, for example because the observed transaction is not the entire transaction between the parties, or one or both parties are not knowledgeable or willing, or their actions are influenced by related party relationships, or government regulates the exchange prices for the transaction in question. We also believe that the historical cost of some assets may differ from fair value because of entity-specific advantages and disadvantages compared to the market. However, many major economies have laws, such as competition laws, which aim to reduce the extent to which these advantages and disadvantages affect exchange transaction prices.

Assets acquired and liabilities incurred in exchange transactions will usually have a determinable historical cost. Exceptions include multiple-element or ‘package’ transactions; identifiable assets and liabilities in business combinations; non-monetary exchanges of assets and liabilities; and share based payment transactions. Because initial recognition still arises from an exchange transaction, we agree that fair value is the most relevant measurement basis for assets and liabilities in these transactions, and should be used if it can be determined reliably. Allocation issues in multiple-element transactions which are not business combinations can be addressed by using relative fair values.

Entities also acquire assets in non monetary contributions from owners, and incur liabilities in distributions to owners. Because the entity is not giving or receiving consideration, these would not necessarily be considered exchange transactions from the viewpoint of the entity’s accounting, and the assets and liabilities do not have a historical cost. However, these transactions are economically similar to exchanges. We agree with the approach followed by existing accounting practice, under which the entity would measure these assets and liabilities at fair value.

An entity might also acquire assets in other ways, for example by gift from an unrelated party, or through the operation of law or the provisions of an existing contract without an exchange transaction, and therefore without historical cost. These assets may or may not have a reliably measurable fair value. These cases are rare, and we express no view on their measurement.

Some liabilities, such as income taxes which are outside the scope of the paper, liabilities imposed by newly enacted legislation, litigation claims, and environmental remediation, do not have a historical cost in the sense that the entity receives no value or consideration in exchange for incurring the liability. Fair value is also not normally relevant to these types of liabilities because they are not normally exchanged, being by their nature specific to the entity. For our views on how these should be measured on initial recognition, please see our answer to question 10 above.

Overall, however, it would be our preference for historical cost to be used as the basis for measurement on initial recognition except in certain circumstances such as the above where fair value can be demonstrated to give better information for the users' purposes.

We do not believe the paper has made a sufficiently strong case for concluding that fair value is most relevant measure on initial recognition of all assets and liabilities when it is reliably measurable. There could be an argument for using fair value in preference to entity specific initial measurements because gains and losses arising from the entity's use of its strengths and weaknesses would be reported in performance as soon as an asset or liability is initially recognized. However, recognising assets and liabilities at fair value on initial recognition could also result in measurement inadequacies, market imperfections and market movements during order lead time being recognised as day one gains, and it is not clear why that would improve the decision-usefulness of financial 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 assists in arriving at the overall value of the business and/or provides the best (ie market) expectation of future cash flows—and a performance reporting presentation should then be chosen that extracts as much useful information as possible out of the gains and losses recognised. We note that such a view:

- places considerable reliance on good performance reporting presentation in order that these day one gains can be separated from other components of performance;
- highlights 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.

In circumstances such as the retailers' property example described in our answer to question 6 above, users would however have to identify and eliminate differences between market values and entity-specific values when preparing their forecasts of future cash flows.

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 because there is no exchange market for some common types of assets and liabilities.

We do not agree that the onus should be on the reporting entity to demonstrate that the exchange prices of its transactions represent fair value, as paragraphs 243 to 252 appear to suggest. We do not see how accounting standards based on this requirement could be put into practice. If it cannot be presumed that the majority of actual exchange transaction prices do represent fair value, it seems to us that this would destroy rather than strengthen the relevance of fair value as an initial measurement basis.

We agree that, in a market value measurement environment, a measurement model or technique could not 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. We also agree with the paper that there are some assets and liabilities for which entity specific initial measurement using such models could nevertheless be the most relevant basis.

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. It follows from the paper's acceptance of the market value measurement objective that the alternative bases are only considered as substitutes for fair value when fair value cannot be measured. In our view, this premise has led to the analysis overstating the strengths of fair value and weaknesses of other bases, especially of historical cost, and understating the weaknesses of fair value and strengths of other bases, especially of historical cost. In particular, the arguments for rejecting historical cost as a surrogate for fair value on initial recognition seem to us to be fundamentally flawed.

Historical cost

We agree that historical cost is not automatically a measure of value received. However, as we said in our answer to question 1 above, if historical cost is measurable, recoverability implies re-measurement and is therefore in our view not a relevant consideration for an initial measurement. Measurement theory must assume economically rational behaviour and therefore that an entity does not incur costs unless the economic benefits of incurring them are estimated to be at least equal to those costs at the date they are incurred. We accept that changes in market conditions, or management errors in estimating costs and benefits, may result in the accumulated historical cost of an asset proving not to be recoverable. That assessment is made only with hindsight and is a re-measurement. Also, in our view it provides much better information to financial statement users if such costs which are no longer expected to be recoverable are presented as asset re-measurements, and not simply combined with other period expenses.

We agree that liabilities should not be measured on the basis of the fair value of the consideration received when this does not reflect the amount owing. The examples given in paragraph 289 on this point are of liabilities not incurred in an exchange transaction. As we said in our answer to question 14 above, we do not believe that fair value is a relevant measurement basis for those types of liabilities, because fair value implies an exchange transaction. Those types of liabilities are not normally exchanged.

For the reasons we state in the third paragraph of our answer to question 14 above, we believe that transactions where an asset's historical cost differs materially from its fair value on initial recognition are not the norm, except perhaps where the process of acquiring or creating the asset is complex – in which case estimating fair value reliably may be difficult. Paragraph 295 argues that if initial measurement differs from fair value, the reported profit or loss when the asset is ultimately realized through sale or use will not distinguish the net income effects of activities relating to the acquisition or creation of the asset from the net income effects of subsequent activities. This can only mean that the authors consider it more informative if all differences between historical cost and fair value are reported in full in net income for all types of assets when they are first recognized, regardless of the reason for those differences. If the differences arise from the entity's advantages and disadvantages compared to the market during the asset acquisition process, such as ability to manage complexity, we do not agree that to carry forward the asset's historical cost results in a less informative matching in later periods. The presentation implied by the paper may have some value in predicting similar differences which may arise in future acquisition activity. However, it has no value, and indeed may be positively misleading, in predicting future benefits from the acquired asset. For this reason, this presentation would make an overall evaluation of the entity-specific component of the total economic benefits from the asset more difficult. This reduces the decision usefulness of the information to investors when they assess overall entity-specific advantages and disadvantages, which we would argue are more important than advantages or disadvantages associated with particular entity functions such as asset purchasing or manufacture. If the differences between cost and fair value arise from any other reason related to the asset acquisition transaction, they are perhaps less likely to recur, and have little or no value even in predicting the results of future asset acquisition transactions. The other possibility is that the differences represent inaccuracies in measuring fair value, as opposed to economic gains or losses relative to fair value.

If a market value measurement objective were chosen, we would accept that it would be appropriate to adjust the historical cost of some assets to fair value if their value to the entity has no entity-specific features – a 'day 2 profit or loss' - but would argue that this is a re-measurement issue.

We agree with the statement in paragraph 298 that historical cost has limited predictive value of itself. It could be argued that its predictive value is neutral and we would argue that that is appropriate on initial recognition. Using fair value on initial recognition is not neutral if significant day 1 profits or losses are reported.

We agree that cost allocation issues pose some challenges to the reliability of historical cost measurements. However, the need to allocate consideration in multiple-element transactions, and to distinguish between costs which are part of fair value and transaction costs, shows that using fair value measurement does not necessarily avoid cost identification issues of this type. Nor are the other measurement bases analysed immune from such issues; for example, value in use calculations involve decisions on which costs should be included in the cash flows which are to be discounted; net realizable value calculations involve decisions on which costs should be included in costs to complete and in selling costs. Paragraph 309 comments that *“Specified allocation rules dictated by standard setters will result in some standardization of historical cost measurements, thus improving verifiability and, possibly, comparability.”* In our view, standard setters should pursue giving principle-based guidance in this area as the way forward, rather than discarding historical cost as a measurement basis because of the perceived intractability of cost allocation issues. The paragraph also says that *“Zero is itself an arbitrary allocation”.* We disagree with this statement. We accept that that a decision not to allocate a particular cost to an asset, on the grounds that there is no reliable allocation basis, will always involve judgement. It does not follow, however, that such a decision is always arbitrary.

If a market value measurement objective were chosen, we agree that the inclusion of pre-recognition costs in asset values would have to be addressed. In our view, any solution depends upon whether an asset exists immediately after the costs have been incurred. For intangible assets, if there is no feasible technology once the costs have been incurred, an asset does not exist and the costs should be expensed. Any future costs which create a feasible technology will, by definition, have been spent on something separate. However, if the costs have created a technology which may lead to economic benefits in future, a probability judgement would be required about whether the project in question will lead to an asset. If this is considered probable, the costs should be recognized as assets and an impairment loss recorded if no asset results – for example, if the project which incurs the costs is abandoned before sustainable economic benefits are generated.

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. For example, while management intentions, assumptions and expectations may be subjective, an observed transaction price is an objective fact. The choice of a cost allocation basis may be based on a subjective judgement; however, the total of a particular type of period cost which is to be allocated will usually be objectively verifiable.

Current cost

In our opinion, current cost could be a relevant asset measurement basis only if the entity will replace the asset or at least its function and capacity. This may be unknown. This makes current cost less relevant than historical cost as a measurement basis for non-current assets, because their historical cost is an economic reality. Therefore, we do not agree with the proposed relevance hierarchy in paragraph 353 which places current cost above historical cost as a general principle. We agree that there are cases in which current cost could be more relevant, but these are exceptions: an entity's need to replace inventories of commodities which it has produced and which meet its own sale or use requirements is clear, unless the entity is no longer a going concern. Current cost may be more a more relevant measurement basis than either historical cost or fair value for these inventories. The requirements in existing accounting standards recognize this.

If historical cost is not determinable, we agree that fair value is normally more relevant than current cost for assets and liabilities recognized as a result of exchange transactions. For example, the fair value of the asset given up appears a more relevant basis for measuring non-monetary exchanges of assets than the current cost of the assets given or received. However, it may be necessary to use replacement cost in business combinations, or multiple-element 'package' transactions, for non-current assets and inventories. We agree that relevant market sources may not give a reliable fair value for specialized non-current assets. Existing business combination accounting standards already recognize replacement cost as an initial measurement basis for raw material inventories. In our view, it would also be a more relevant basis than fair value for work in progress and finished goods inventories, even when fair value can be measured from the market of sale; referring to the markets in which the inputs used to make the inventories were acquired, results in accounting more consistent with the accepted revenue recognition criteria which will apply after the inventories are sold and replaced.

We agree that current cost is not a measure of value received. Unlike historical cost, recording an asset's current cost is not a necessary part of recording exchange transactions which lead to its initial recognition. We therefore agree that there would have to be a recoverability limit on an initial measurement based on replacement cost.

We agree that replacement cost is not normally relevant to the initial measurement of liabilities.

Net realizable value

Generally, we agree with the conclusion in paragraph 375 that there is no role for net realizable value in the measurement of assets and liabilities on initial recognition. We see one exception: where assets are acquired exclusively for resale in business combinations or multiple-element package transactions, net realizable value seems the most relevant initial measurement basis for the assets and liabilities associated with them.

Value in use

If historical cost is determinable, we would argue that value in use can be applied only as a re-measurement, because accounting for the transaction which leads to initial asset or liability recognition has to include accounting for its cost. We agree that value in use could be an acceptable substitute for fair value in initial asset recognition situations such as business combinations in which historical cost of individual assets and liabilities is not determinable, if fair value is not available from observed market prices, value in use techniques are applied as indicated in paragraph 386, and the cash flows attributable to the asset can be identified. However, if cash flows can be identified only at a cash generating unit level higher than the asset being measured, value in use could not be a relevant initial measurement basis for the asset.

We agree that the “cost of performance” basis, as defined in paragraph 384, could be the most relevant initial measurement basis for certain liabilities with entity-specific features, where management’s actions can affect the cash flows of the liability. This would include both liabilities which are not incurred in exchange transactions, and some liabilities assumed in exchange transactions, such as performance obligations assumed within contracts to purchase assets, and long-term employee benefit liabilities. Fair value may not be reliably measurable for many of these liabilities, as there may be few or no parties willing to take over the liability, but we would argue that in any case fair value is not relevant unless the entity will extinguish the liability by exchanging it. Net realizable value would also not be relevant if the liability cannot or will not be settled, as opposed to being extinguished by performance.

Deprival value

Paragraphs 403-4 argue that deprival value has decision usefulness for internal management purposes but that it is nevertheless not relevant for initial financial reporting measurement, although disclosure may be warranted. The paper does not explain why deprival value measurement in financial statements would not improve their decision usefulness for investors, compared to mere disclosure. Shortcomings in financial statement measurement are not rectified adequately by disclosures. For example, when investors are considering whether management should divest an existing asset or component of the entity, or are assessing management performance, there could be advantages in having fully congruent internal and external measurement.

However, if historical cost is determinable, we would argue that deprival value can be applied only as a re-measurement, for the reasons argued above.

The main advantage of deprival or relief value is that several different measurement bases must be compared, which increases the chance of finding the most relevant basis. For example, deprival or relief value seems a more relevant basis for measuring liabilities than either net realizable value or value in use when the entity has a choice of settling the liability or extinguishing it through performance. However, this feature of deprival value brings a strong corresponding practical disadvantage: it is complex to calculate. In our view, this generally makes it unsuitable as an initial measurement basis.

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.*

It seems reasonable that, where market value is the measurement objective, but another measurement basis than fair value is used as a substitute, that basis would have to be applied as consistently as possible with the objective. However, we do not think the issue is as simple as the paper suggests. We suspect that, when it is not possible to estimate a fair value reliably, fair value may actually not be the most relevant measurement basis either. 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 would be even less valid.

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.*

If a market value measurement objective were chosen, we would agree with the proposed hierarchy for asset and liability measurement where the measurement objective is fair value. However, as argued above, we believe entity-specific measurement objectives could result in more relevant measurements for certain assets and liabilities.

The proposed hierarchy is presented in terms of numbered levels and could very easily be confused with the hierarchies published in recent pronouncements of other standard setters, such as the FASB fair value measurement ED, or Appendix E of the IASB exposure draft of proposed amendments to IFRS 3, *Business Combinations*. These hierarchies use the same numbering convention for their levels, but the definitions of individual levels by one standard setter are not always identical with those of other standard-setters. Using a different numbering and/or presentation would have made it easier to discuss the proposals in the paper outside the context of the paper itself.

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 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.

* allocated goodwill 0 + 20% of identified assets/liabilities 30

Thus, on equity – controlling interest, we have a reduction of CU 5 (170 → 165). How is this to be shown and described in the statement of changes in equity?

Question 4

Do paragraphs A8-A26 in conjunction with Appendix E provide sufficient guidance for measuring the fair value of an acquiree? If not, what additional guidance is needed?

We have already explained above why we find the proposed „acquisition method“ unacceptable. Expanding on our previous comments, we emphasise that, even with the guidance given, the measurement would reflect a high level of subjectivity, especially when unquoted businesses are acquired. Novartis' recent offer of $40 per share for the remaining 57.8% of Chiron compared to a stock market price of $36.44 before the bid and a price of $43.13 in early trading after the bid. An 18% spread of possibilities, and that in a highly liquid market for a quoted US company! Example 3 in A15 also demonstrates some of the difficulties. The example gives the impression that what the other bidders were prepared to pay for the interest in the acquiree would be of no relevance in determining the fair value of the acquiree as a whole. We would have thought that information may well be relevant. The exercise which acquirers are being asked to carry out is clearly not as straightforward as it may at first seem. Under such circumstances we find that the historical cost of the transaction remains the appropriate value for recording the transaction as it is more transparent, more reliable and also more relevant to users of the parent's consolidated financial statements.

Question 5

Is the acquisition-date fair value of the consideration transferred in exchange for the acquirer's interest in the acquiree the best evidence of the fair value of that interest? If not, which forms of consideration should be measured on a date other than the acquisition date, when should they be measured, and why?

We have already explained above why we find the proposed „acquisition method" unacceptable. If the Board were nonetheless to insist on implementing the proposal, we could broadly agree with this presumption, though we have doubts as to whether the fair value of the consideration transferred should logically include any previously held interest.

Question 6

Is the accounting for contingent consideration after the acquisition date appropriate? If not, what alternative do you propose and why?

Assuming that the proposed approach of acquisition date fair value measurement of the acquiree is the method adopted, the accounting for contingent consideration after the acquisition date is appropriate. However, as already expressed, we have difficulties with the proposed general approach and prefer the cost method of the current IFRS 3, with contingent consideration being recognised only when certain criteria are met. Further, we believe that the proposed approach bears the risk that in practice entities may be tempted to increase the use of contingent considerations and as a consequence benefit from higher equity numbers.

Question 7

Do you agree that the costs that the acquirer incurs in connection with a business combination are not assets and should be excluded from the measurement of the consideration transferred for the acquiree? If not, why?

We have already explained above why we find the proposed „acquisition method" unacceptable and prefer the cost method of the current IFRS 3, under which it is logical to include in the cost of acquisition the direct incidental costs of the transaction in line with other asset acquisitions. Even if the Board were nonetheless to insist on implementing the proposed acquisition method, we believe that it would still be appropriate to include these costs: whether they are paid to the seller or to a third party (e.g. legal consultants), they are still part of the fair value of consideration for the transaction. The arguments in BC86 do not hold up as a successful acquisition cannot be regarded in the same light as an abortive one.

Question 8

Do you believe that these proposed changes to the accounting for business combinations are appropriate? If not, which changes do you believe are inappropriate, why, and what alternatives do you propose?

We can broadly accept the initial recognition and measurement changes for identifiable assets acquired and liabilities assumed, with the following reservations:

- Contingencies: Probability is a key asset and liability recognition criterion according to the Framework. The proposals contradict the Framework by treating probability as a measurement attribute and are for this reason unacceptable. See our general comments above as well as our comments on the draft amendments to IAS 37. Removing the recognition criterion will result in forecast outcomes which are improbable being used to support amounts recorded in the financial statements, which we find highly undesirable in respect of both relevance and reliability.

- We have in practice found the guidance in B16 of the current IFRS 3 to be very useful and would welcome similar “tips” on specific assets and liabilities in any revision. However, it is appreciated, as discussed in our general comments, that general debate on fair values must come first.

- As a matter of practicality, we suggest that a global valuation allowance for uncollectible receivables should be permitted as an alternative to a separate valuation of each item, which can be very cumbersome when an acquisition includes a large portfolio of debtors.

- The draft revised IFRS 3 in paragraphs 28 to 31 no longer mentions the “reliability of measurement” recognition criterion. In BC98 of draft revised IFRS 3 the Board explains that it decided to drop the notion because an equivalent statement is already part of the recognition criteria in the Framework (paragraph 86 – 88). Based on our understanding that the Framework cannot supersede a standard and to prevent uncertainty, we recommend the Board to reinstate this recognition criterion in the revised IFRS 3 or - as a minimum – include a direct reference to the Framework paragraph.

Question 9

Do you believe that these exceptions to the fair value measurement principle are appropriate? Are there any exceptions you would eliminate or add? If so, which ones and why?

If the Board were to proceed with the proposed acquisition method, we agree that the exceptions would be appropriate and enable the accounting principles established for certain assets and liabilities in specific standards to be applied subsequent to the business combination. As a further suggestion, however, we would favour the addition of a practical simplifying change to permit the valuation of manufactured WIP and finished goods inventories at replacement cost as a surrogate for fair value, as is already done with raw material inventories and specialised equipment. This would be a substantial practical help in reducing the compliance costs and simplifying the accounting.

Question 10

Is it appropriate for the acquirer to recognise in profit or loss any gain or loss on previously acquired non-controlling equity investments on the date it obtains control of the acquiree? If not, what alternative do you propose and why?

We believe that this approach is inappropriate. No realization has taken place, and nothing leaves the Group. The valuation adjustment – if made at all – should be held in equity until a disposal takes place, which would also be more understandable in the consolidation process and in line with other IFRS (e.g. IAS 31). We agree with the two dissenting Board members on this point.

We would also like to request that, if the Board retains the ED proposal, quite clear principles – with examples – are included in the standard to explain exactly how entities are to report changes in the levels of control that are key for financial reporting purposes. Shares being acquired or disposed of leads to movements between categories (investments/associated companies/subsidiaries), and the reporting and disclosure consequences of this are somewhat opaque in the present draft.

Furthermore, under the existing IFRS 3, certain auditors are producing interpretations that the amount to be recorded in equity as a result of taking control needs to be recorded in a separate equity component account to be kept until the subsidiary is sold.

We request that any amendments to IFRS 3 clarify that separate disclosure within equity is not required, and this adjustment can form a part of consolidated retained earnings, and that this new guidance can be applied retrospectively to all transactions since the effective date of the current IFRS 3 of March 31, 2004.

Question 11

Do you agree with the proposed accounting for business combinations in which the consideration transferred for the acquirer's interest in the acquiree is less than the fair value of that interest? If not, what alternative do you propose and why?

Assuming the adoption of the fair value approach, we agree with this as a pragmatic solution. What is unclear, however, is the Board's criterion for deciding when, as here, to permit practical solutions which are inconsistent with the principles adopted.

Question 12

Do you believe that there are circumstances in which the amount of an overpayment could be measured reliably at the acquisition date? If so, in what circumstances?

We believe that it would be extremely difficult to measure an overpayment objectively and reliably, but that is because we take the view – as expressed earlier – that it is often difficult to measure the fair value of the acquiree reliably. Also, as mentioned in the Basis for Conclusions, the first impairment testing would catch the effects in any case. Consequently, we could accept the pragmatic solution proposed, assuming that the fair value approach is adopted.

Question 13

Do you agree that comparative information for prior periods presented in financial statements should be adjusted for the effects of measurement period adjustments? If not, what alternative do you propose and why?

We agree that comparative information should be adjusted for effects of measurement period adjustments.

Question 14

Do you believe that the guidance provided is sufficient for making the assessment of whether any portion of the transaction price or any assets acquired and liabilities assumed or incurred are not part of the exchange for the acquiree? If not, what other guidance is needed?

A clear principle would far better achieve the objective than detailed guidance. That provided is quite detailed and lengthy and gives the impression that it is drafted mainly to prevent abuse. In any case preparers would in practice need to use judgement to make this assessment.

Question 15

Do you agree with the disclosure objectives and the minimum disclosure requirements? If not, how would you propose amending the objectives or what disclosure requirements would you propose adding or deleting, and why?

The changes in the disclosure requirements follow logically from the other changes proposed. They should stand or fall in the final version according to the final decisions on those other changes.

An additional issue concerns the disclosures of the ED on IFRS 3. Para 76 (b) requiring the disclosure of the movement of the contingent consideration during the period. Such a requirement could cause problems in case of a step acquisition of a private company. In those types of deals, especially when the steps are based on an earn-out formula, the parties agree in the contract that terms of the agreement are confidential. Therefore, business practice requires that the Board establishes a waiver to this disclosure requirement when it could cause legal prejudice to the entity as is already the case in IAS 37 § 92 (current standard).

Question 16

Do you believe that an intangible asset that is identifiable can always be measured with sufficient reliability to be recognised separately from goodwill? If not, why? Do you have any examples of an intangible asset that arises from legal or contractual rights and has both of the following characteristics:

(a) the intangible asset cannot be sold, transferred, licensed, rented, or exchanged individually or in combination with a related contract, asset, or liability; and

(b) cash flows that the intangible asset generates are inextricably linked with the cash flows that the business generates as a whole?

Contrary to the assertions in paragraph 29, the proposals in paragraphs 40-41 and A28-34 are inconsistent with both the Framework and IAS 38 on intangible asset recognition, as paragraphs 40 and A28 only refer to definition (IAS 38, 10-17) and not to the recognition criteria (IAS 38, 21-22), which include reliable measurement. This clearly weakens the credibility of the proposals by seemingly seeking to ignore key items in both the Framework and IAS 38. We fully support and agree with the alternative view expressed in AV19 in this regard and look forward to the Board re-instating the reliable measurement criterion in any final standard. It is particularly relevant in an area like intangible assets where an active market giving reliable data is the exception rather than the rule.

Question 17

Do you agree that any changes in an acquirer's deferred tax benefits that become recognisable because of the business combination are not part of the fair value of the acquiree and should be accounted for separately from the business combination? If not, why?

Assuming the adoption of the fair value approach, this would be logical.

Question 18

Do you believe it is appropriate for the IASB and the FASB to retain those disclosure differences? If not, which of the differences should be eliminated, if any, and how should this be achieved?

Especially on joint projects, the Boards have not done their job unless all divergences have been removed, so we are disappointed at their failure to do so here. We hope that the remaining divergences are not used an excuse by regulatory authorities to continue to require reconciliations and/or additional disclosures. Although the Boards cannot control this, the possibility should alert them to the need to ensure that divergences are eliminated.

Question 19

Do you find the bold type-plain type style of the Exposure Draft helpful? If not, why? Are there any paragraphs you believe should be in bold type, but are in plain type, or vice versa?

We principally agree with the bold type/plain type distinction and find it helpful. We have not (yet) identified any paragraphs which should be changed from one typeface to another. We also warmly support the suggestion to present arguments on accounting treatments in Basis for Conclusions in future exposure drafts in pro/con tabular form.

We thank you for your attention to the above.

Yours sincerely

FEDERATION OF
SWISS INDUSTRIAL HOLDING COMPANIES

Dr. Peter Baumgartner Chairman Executive Committee	Dr. Jan Atteslander Member Executive Committee

cc - IH Committee
- IH Expert Group Accounting and Reporting