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Director – Accounting Standards
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Dear Sir/Madam

Discussion Paper: Measurement Bases for Financial Accounting

The Group of 100 (G100) is pleased to provide comments on the Discussion Paper (DP) and in doing so, has focused on the condensed version. The G100 represents the interests of the CFOs of Australia's major business enterprises.

The G100 supports efforts to develop the conceptual basis of accounting and the identification of broad principles. However, in addressing the issues in the DP we have the following general comments:

- in view of the IASB/FASB convergence project and the FASB's current work on fair value measurement and applying fair value measurement we are unsure of how the approach proposed in the DP is meant to interact with the objectives of the convergence project. We have the impression that this project has been overtaken by subsequent developments of the project on fair value measurement. Our preference would be to follow the IASB/FASB convergence route;
- the presumption that efficient markets are available in respect of all types of assets and liabilities. We do not believe that this is generally the case and is not borne out in respect of a range of financial instruments and derivatives where this might be expected to be the case; and
- while we acknowledge the objective of dealing with the measurement issue in stages, the focus on initial measurement is too narrow as we consider that the issues should also be considered in the context of subsequent measurement.

Our responses to the questions are set out below.

Q1. *Do you agree that the list of identified possible measurement bases (see paragraphs 33-51 of the condensed version and paragraphs 69-74 of the main discussion paper) sets out the bases that should be considered? If not, please indicate and explain any changes that you would make.*

Yes. However, if a more specific definition of fair value is adopted different variants of this measure would need to be discussed.

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

We believe there is a need to clarify what is meant by fair value before comparing it with other measures and using it as a basis for measurement and recognition. At present there is a difference between the definition of the term in IFRS and the DP and that currently proposed by the FASB. For example, what is the objective of using the term 'fair value'; is it intended to capture market-based measurements or is it intended to deal with entity-specific measurements?

Q3. It is proposed that there are two fundamental sources of differences between the identified bases for measuring assets and liabilities on initial recognition:
(a) market versus entity-specific measurement objectives, and
(b)differences in defining the value-affecting properties of assets and liabilities.

(See paragraph 52 of the condensed version and paragraph 97 of the main discussion paper.) This proposal and its conceptual implications are the subject of chapters 4 and 5. Do you agree that these are the fundamental sources of differences between asset and liability measurement bases on initial recognition? If not, please indicate the fundamental sources of differences you have identified, and provide the basic reasons for your views. For any different fundamental sources you have identified, please indicate how these might be examined and tested.

The G100 agrees with the main sources of differences identified for measuring assets and liabilities on initial recognition and consider that the impact of these factors should be discussed more fully than appears in the DP. We have the following concerns:

- **whether there can only be one fair value for an asset or liability on initial recognition when market evidence often indicates otherwise;**
- **the differentiation in respect of transaction costs.**

Q4. The paper analyzes the market value measurement objective and the essential properties of market value.

a) Do you believe that the paper has reasonably defined the market value objective and the essential properties of market value for financial statement measurement purposes (see paragraphs 54-56 and 105-112 of the condensed version and paragraphs 99-110 and 236-241 of the main discussion paper)? If not, please explain why not, and what changes you would propose, or different or additional considerations that you think need to be addressed.

It is not clear to us why a convention in respect of market value measurement applied in the finance literature can be transported to financial reporting without an analysis of its features, why it is appropriate, the implications of its use and the shortcomings of its application.

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.*

The G100 agrees with the definition of market.

c) *Do you agree with the fair value measurement objective as proposed, and its derivation from the market value measurement objective (see paragraph 102 of the condensed version and paragraphs 111, 228 and 229 of the main discussion paper)?*

The use of market value as one of a hierarchy of measures of fair value is supported. However, the existence of a market value should not be taken as exclusive evidence that it is the appropriate measure of fair value. Whether this is so will depend on a range of factors including whether fair value is regarded as a market-based on entity specific measure.

The value of an asset on initial recognition is likely to be no less than its cost and no greater than that amount. If the decision to acquire the asset was economically rational, then the asset on initial recognition is expected to bring at least as much value to the acquirer as the cost incurred to acquire it.

Rational decision making would also suggest that the asset has been acquired by the most economic means possible, there seems no reason for any higher value to be reflected in the carrying amount of the asset especially if an equivalent asset could be obtained for the same cost.

It is however noted that there are limited circumstances when these assumptions will not hold, and the use of historical cost many not be justified. For example, where an entity constructs plant for its own use and there are cost inefficiencies (for example if installation has been delayed by industrial disruption) then not all the costs (including capitalised interest) incurred may be capitalised without the risk of recognizing the asset above its recoverable amount.

Q5. *Do you agree with the definition and discussion of entity-specific measurement objectives (see paragraph 57 of the condensed version and paragraphs 112-116 of the main discussion paper) and their relationship to management intentions (see paragraph 58 of the condensed version and paragraphs 117-121 of the main discussion paper)? If not, please explain why you disagree.*

While the G100 generally agrees it is noted that market-based measures relate to the current price (spot price) for the marginal trade of a (generally) specified quantity. Measuring the amount of an asset by applying the spot price does not necessarily reflect a reliable measure of its value. This is particularly so where fair value is seen as an entity-specific measure.

The proponents of 'fair value' suggest that two entities that own identical assets should report them at the same amount in their financial statements (where initially recognizing them at the same point in time), eliminating what has been called 'entity specific values'. This , it has been suggested, will enhance comparability.

However, the term 'entity specific' contains an important ambiguity. It has been defined in the Discussion Paper as a 'measurement of an asset or liability that is based on the expectations of management of an entity'. On that definition it is difficult to defend 'entity specific' measurement bases, since financial reporting should reflect the economic resources controlled by an entity and the claims on those resources, mere expectations do not affect these resources.

However, if it is acknowledged that economic constraints and opportunities differ between entities, the case that similar assets might be reported at different amounts is plausible. For example, one airline may acquire aircraft in sufficient quantity that it obtains a large discount. This may result in those aircraft being recognized at a lower amount than another airline that acquires substantially fewer aircraft and does not receive the same discount. Similar asymmetrical outcomes may also exist between a wholesaler and retailer holding the same goods. The assertion that these differences in value are attributable to differences in expectation is contested, rather it is suggested that the differences are due to observable facts.

Q6. Do you agree with the comparison of market and entity-specific measurement objectives (see paragraph 59 of the condensed version and paragraph 122 of the main discussion paper) and with the proposed conclusion that the market value measurement objective has important qualities that make it more relevant than entity-specific measurement objectives for assets and liabilities on initial recognition (see paragraphs 60-61 of the condensed version and paragraphs 123-129 of the main discussion paper)? If not, please explain your views.

No. The presumption in the DP is that market value measures are superior to entity-specific measures which may also include the use market values. However, there seems to be a lack of argument to support the assertion that market value measures are superior.

Q7. a) It is reasoned that there can be only one market (fair) value for an asset or liability on a measurement date (see paragraph 62 of the condensed version and paragraphs 131-138 of the main discussion paper). Do you agree with this conclusion? If not, please explain why you disagree.

No. The existence of only one market value assumes the existence of a perfectly efficient market. We believe that there is sufficient evidence of inconsistencies within and between markets to challenge this assertion, for example, the market prices on difference exchanges for securities of dual listed entities and the existence of opportunities to arbitrage.

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.

The G100 agrees with the analysis in paragraph 136 of the DP.

Q8. Do you agree that a promise to pay has the same fair value on initial recognition whether it is an asset or a liability, and that the credit risk associated with a promise to pay enters into the determination of that fair value with the same effect whether it is an asset or liability (see paragraph 65 of the condensed version and paragraphs 142-147 of the main discussion paper)? If you do not agree, please explain the basis for your disagreement.

In our view changes in the entity's credit ratings are reflected in the market value of its liabilities. However, we disagree that the credit risk of the entity should be reflected in the measurement of liabilities in its financial statements. Credit risk at the time of a contract will be reflected in the terms of the contract including the ongoing servicing cost. In addition, the entity is obliged to settle the contracted amount of a liability and not the market value of the liability.

Q9. The paper makes the following proposals with respect to defining the unit of account of the asset or liability to be measured on initial recognition:

a) *The appropriate individual item or portfolio unit of account on initial recognition is generally the unit of account in which the reporting entity has acquired the asset or incurred the liability (see paragraphs 67-70 of the condensed version and paragraphs 149-154 of the main discussion paper).*

Yes. Where an entity purchases an asset (portfolio) with the intention to hold and sell the portfolio, the appropriate unit of account is the portfolio and not its individual components.

b) *The appropriate level of aggregation for non-contractual assets on initial recognition is the lowest level of aggregation at which an identifiable asset is ready to contribute to the generation of future cash flows through its sale or use (see paragraphs 71-73 of the condensed version and paragraphs 157-161 of the main discussion paper). Do you agree with these proposals within the caveats and discussion presented? If not, please explain why, and in what respects, you disagree.*

Yes.

Q10. It is suggested that, in many cases, the best market source on initial recognition is the market in which the asset or liability being measured was acquired or issued. However, some significant situations are noted in which a different source may be appropriate, and research is proposed into possible multiple markets (see paragraphs 75-82 of the condensed version and paragraphs 162-182 of the main discussion paper). Do you agree that the paper provides a reasonable analysis of market sources and their implications on initial recognition? If not, please provide reasons for disagreeing, and indicate any additional analysis or research you would think should be carried out.

The G100 is concerned that the conclusions are based on the presumption there is an efficient market which provides a single fair value. Evidence from the operation of actual markets indicates that this proposition is not necessarily the case.

Q11. The paper concludes that transaction costs, as defined, are not part of the fair value of an asset or liability on initial recognition (see paragraphs 86-87 of the condensed version and paragraphs 193-200 of the main discussion paper). Do you agree with the proposed definition of transaction costs? Do you agree with the above conclusion? If you disagree, please explain your reasons and what you believe the implications of your different view would be for fair value measurement of assets and liabilities on initial recognition.

The G100 is concerned about the approaches to transaction costs. We accept that if market-based measurement is used then recoverability of costs incurred may be used as a basis for determining the treatment of transaction costs.

In most cases the use of market values would preclude the capitalization of transaction costs. However, where an entity acquires an asset with the intention to consume all its services over its economic life (whether market-based or entity-specific measures are adopted) it will seek to recover all of its costs (including transaction costs) and earn an acceptable return on those costs irrespective of their nature and type.

Q12. Do you agree with the proposal that, when more than one measurement basis achieves an acceptable level of reliability, the most relevant of these bases should be selected (see paragraph 89 of the condensed version and paragraph 202 of the main discussion paper)? If not, please explain why you disagree, and indicate how you would settle trade-offs between the relevance and reliability of alternative measurement bases.

The G100 does not believe that it is simply a matter of relevance and reliability and that other qualitative characteristics of information such as comparability, understandability need to be considered in the context of achieving accountability to shareholders and satisfying the objectives of financial statements.

Q13. Do you agree with the two proposed sources of limitations on measurement reliability — estimation uncertainty and economic indeterminacy — and supporting discussion (see paragraphs 90-100 of the condensed version and paragraphs 204-216 of the main discussion paper)? If not, please explain your view.

While the G100 has no major objections to this discussion we believe it is necessary to illustrate and explain what is meant by 'sufficient reliability' including for what purpose and for whom the measurements are being reported.

Q14. Do you agree that fair value is the most relevant measure of assets and liabilities on initial recognition of assets and liabilities, and therefore should be used when it can be estimated with acceptable reliability (see analyses of fair value and alternative bases in chapter 7, and discussion of measurement date on initial recognition in paragraphs 179-180 of the condensed version and paragraphs 410-415 of the main discussion paper)? If not, please explain why.

The G100 is not convinced that fair value is the most relevant measure on initial recognition.

Q15. Do you agree that fair value is not capable of reliable estimation in some common situations on initial recognition (see paragraph 104 of the condensed version and paragraphs 232-277 of the main discussion paper)? More specifically, do you agree that:

a) A single transaction exchange price should not be accepted to be equal to fair value unless there is persuasive evidence that it is (see paragraphs 106-114 of the condensed version and paragraphs 243-252 of the main discussion paper), and

b) A measurement model or technique cannot be considered to achieve a reliable estimation of the fair value of an asset or liability when the estimate depends significantly on entity-specific expectations that cannot be demonstrated to be consistent with market expectations (see paragraphs 115-118 of the condensed version and paragraphs 263-268 of the main discussion paper)?

Please provide explanations for your views on these questions if they differ significantly from the conclusions and supporting arguments presented in the paper.

a. Yes.

b. Yes, if the objective is to achieve market-based measurement. However this position will be different if the objective of fair value was to apply entity-specific measurement.

Q16. Do you agree with the paper's analyses and conclusions with respect to the comparative relevance and reliability of:

a) historical cost (see paragraphs 120-137 of the condensed version and paragraphs 281-319 of the main discussion paper);

b) current cost — reproduction cost and replacement cost (see paragraphs 138-154 of the condensed version and paragraphs 320-361 of the main discussion paper);

c) net realizable value (see paragraphs 155-161 of the condensed version and paragraphs 362-375 of the main discussion paper);

d) value in use (see paragraphs 162-169 of the condensed version and paragraphs 376-392 of the main discussion paper); and

e) deprival value (see paragraphs 170-178 of the condensed version and paragraphs 393-409 of the main discussion paper)?

Please provide reasons for any disagreements, and any advice you may have as to additional analysis or research that you believe should be carried out.

The G100's main concern is the presumption as to the appropriateness of fair value in preference to what is described as historical cost. It is our view that in an efficient market the historic cost of say, an asset, and the fair value of that asset necessarily coincide at initial recognition. The principal issue is how to address those cases where at acquisition there is a difference between historic cost and fair value.

Q17. The paper discusses substitutes for fair value when the fair value of an asset or liability cannot be reliably estimated on initial recognition. Do you agree that, when other measurement bases are used as substitutes for fair value on initial recognition, they should be applied on bases as consistent as possible with the fair value measurement objective (see paragraph 186 of the condensed version and paragraph 417 of the main discussion paper)? If not, please explain why.

Yes. However, if a surrogate measure needs to be used it may be necessarily to address whether fair value is the most appropriate measure in the circumstances.

Q18. Do you agree with the proposed hierarchy for the measurement of assets and liabilities on initial recognition (see chapter 8)? If not, please explain your reasons for disagreeing and what alternatives you might propose.

No. The G100 considers that there are too many components to the hierarchy and prefers an approach closer to that proposed by the FASB with fewer levels in the hierarchy.

Q19. Do you have comments on any other issues or proposals, including the proposals for further research (see paragraph 189 of the condensed version and paragraph 441 of the main discussion paper)? If so, please provide them.

No.

Yours sincerely

Tom Honan
National President