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19 May 2006
Peter Martin, CA
Director, Accounting Standards
Canadian Accounting Standards Board
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Dear Sir,

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

Syngenta is an IFRS preparer listed on the Zurich and New York Stock Exchanges. We are writing to comment on the Discussion Paper *"Measurement Bases for Financial Accounting – Measurement on Initial Recognition",* published by the IASB, but we send our comments to you as requested. Our comments are based on the full version of the paper, and our paragraph references refer to that version, and not to the condensed version circulated in hard copy form to IASB subscribers. In our view, it is necessary to refer to the full version in order to consider the implications of the paper. We are commenting not only on the arguments presented in the paper, but also on what we believe they imply for the direction of development of new accounting standards by standard-setters in the medium term future.

We welcome the publication of this discussion paper. The breadth and clarity of the analysis it contains provides an opportunity for those interested in the future direction of accounting to have a comprehensive, timely and global debate on the key issue of measurement. We agree with the decision to limit the scope of the paper to measurement on initial recognition. If re-measurement had been added, in our view the project scope would have been so wide that it would have been difficult to summarise the issues and proposals concisely or to comment on them. However, we have referred to subsequent measurement issues at certain points in our response, because it is difficult totally to divorce discussion of initial measurement from subsequent measurement issues.

We agree that the conceptual framework for accounting has to evolve to deal with changing circumstances, that traditional accounting based on the historical cost convention does not provide a satisfactory answer to many modern accounting problems, and that developments in theory and practice justify reviewing current practices. We also recognise that the paper builds on existing standard-setter pronouncements and other accounting literature. However, we have a number of fundamental concerns regarding the reasoning and conclusions in the paper. These, and other comments, are set out in the appendix to this letter.

We would particularly like to emphasise the following points.

- It could be argued that having a single preferred measurement basis would reduce the complexity of today's accounting standards. However, in our view, it is over-ambitious to try to identify a single measurement basis as being more relevant than all other bases for initial recognition situations generally, as the paper does for fair value. For example, we do not understand how fair value can be a relevant measurement basis for those assets and liabilities which are not exchanged in markets. We doubt that any single basis can address all current initial measurement issues satisfactorily. The paper states that *"the lack of an agreed, coherent measurement theory has impeded the advancement of accounting standards"*. We fear that advancement may also be impeded if an unrealistic goal is set.

- The paper comments that *"some existing standards reflect more or less arbitrary mixed measurement compromises".* Although we agree that an accounting framework must have conceptual rigour, and that existing standards can be improved, we believe that a mixed measurement model should not necessarily be viewed negatively, even if it results from compromises. Appropriate compromise, supported by rational analysis, will continue to prove both necessary and a valuable method of problem-solving. We acknowledge that inappropriate compromises could adversely affect the quality of accounting standards and reported financial information.

- The analysis of "Transaction price" in paragraph 243 to 252 seems to us to suggest that actual transaction prices should not be considered as representing fair value at the transaction date – and consequently should not be the basis for recording the assets acquired and liabilities incurred in the transactions - unless the market has *"sufficiently extensive exchange transactions in an asset or liability to achieve its equilibrium price."* This seems to us to go further than any existing pronouncement of which we are aware, and to be a step too far. We believe that it will be impractical to use the conceptual points which are being made here, to help develop workable future accounting standards on issues which have broad application to routine accounting.

- We believe that the purpose of an entity's financial reporting is to communicate information to the market about the entity which the market does not already have. This new information might cause market assumptions to change, rather than merely confirming already existing market assumptions. For this reason, the market related measurement objective, which necessarily focuses on existing market assumptions, should not be considered more relevant than entity-specific measurement objectives in all circumstances. We would argue that to have different measurement objectives, and therefore different measurement bases, for different types of assets and liabilities, is not inconsistent with the overriding objective of providing useful information for readers of financial statements.

- paragraph 28 of the paper states that the criteria for evaluating different measurement bases should be independent of the bases themselves in order to avoid bias. In our opinion, the paper has not achieved this aim, and we are not sure whether it is even possible to do this. Paragraph 93 (b) states: "it is presumed that the term and definition [of fair value] set out at paragraph 88 should be interpreted to embody the market value measurement objective". It follows from this that the identification of fair value as the most relevant measurement basis is a virtually foregone conclusion once the paper has made the assertion that the market related measurement objective is the most relevant objective. Therefore, we believe the evaluation of bases in the paper is not truly independent of the fair value measurement basis.

- The paper's proposals, if incorporated into accounting standards, would result in controversial 'day 1 profit' recognition on acquisition of many assets and liabilities. For example, the proposal in paragraphs 410 to 415 that assets acquired in fixed price contracts which have a significant order lead time should be recorded at their fair value on their acquisition date would result in 'day 1 profit' (or loss) equal to any increase in the fair value of the asset between order date and acquisition date; also, the hierarchy of fair value substitutes discussed in paragraphs 351 to 361 makes it clear that self-constructed assets with significant construction lead times would often not be measured at accumulated historical cost, resulting in 'day 1 profit' equal to the excess of the amount recognized for the asset over its historical cost. Existing accounting frameworks already require a 'day 1 loss' (i.e. an expense) to be recorded if a transaction does not result in asset definitions or recognition criteria being met, but do not allow 'day 1 profit', because a 'bargain purchase' of an asset is not an accepted revenue recognition criterion when the entity has not yet used the asset.

- We think that a number of important assertions the paper makes are neither generally accepted nor justified in the paper.

Yours sincerely,

James Halliwell
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Syngenta International AG

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 several exceptions and we comment on these below). The entity necessarily has to record that historical cost basis somewhere in the financial statements in the process of accounting for the transaction. 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, in all situations where a transaction amount is also the historical cost of the asset and/or liability which is being exchanged in the transaction, we would argue that measurement bases other than historical cost 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 into account in the paper's conclusions.

Paragraph 135 states an a priori expectation 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 costs that are recoverable in the market place and costs that are not. We do not think this differentiation as currently expressed in the paper is workable, because the recoverability of costs would appear to be more about pricing flexibility than accounting measurement. For example, a re-seller or broker 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 or broker.

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 fair value 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. 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 in many bodies of standards, including IFRS, 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, giving a range of market values. However, in our view, it is 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.

We are not sure whether or not there can be only one market (fair) value for an asset or liability on a given measurement date. However, in our view, fair value could still be measured reliably even if some assets or liabilities do have different fair values in different markets. 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. We believe that a unique fair value on a given date can normally be measured for the asset or liability in that market.

(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 issuer 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 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 is the best source for the measurement amount of the asset or liability on initial recognition.

When assets are acquired and liabilities incurred in business combinations or multiple-element transactions which exchange groups of assets and liabilities, initial measurement of the individual assets and liabilities 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 would usually result in inconsistent measurement of items acquired in transactions with different structures – a recognized problem in modern accounting. For example, initial measurement of some types of inventories based on their entry market and other types of inventories based on their exit market seems to us unjustifiable. Exit markets may need to be considered as part of a recoverable amount test for the inventories, but this would represent a re-measurement, as we have argued above.

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 in a market value measurement model.

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. Disclosing the fair value could be considered in these circumstances if it was considered to have any relevance.

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 predictive value and decision-usefulness.

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; business combinations; non-monetary exchanges of assets and liabilities; and share based payment transactions with employees. 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 making cash distributions to owners. Because the entity is not giving any consideration for the asset or receiving any for the liability, 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, because the owners' interest in the entity increases or reduces by the amount of the contribution or distribution. 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.

We do not believe the paper has made a sufficiently strong case for concluding that fair value is the most relevant measure for the initial recognition of all assets and liabilities, even 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 in acquiring the asset or incurring the liability would be reported in performance as soon as the item 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.

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, absent evidence to the contrary, 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 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. 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.

<u>Historical cost</u>

We agree that historical cost is not 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 which are neither incurred in an exchange transaction, nor normally exchanged. 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.

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 at initial recognition date are reported immediately and in full in net income for all types of assets, 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 its 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.

We would accept that it is 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 significant challenges to the reliability of historical cost measurements. However, the need to allocate costs 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 all 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 this 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.

We agree that the inclusion of pre-recognition costs in asset values must be addressed. If probability of future economic benefits is an asset recognition criterion, an asset might exist without meeting recognition criteria, but a probability judgement can be made about whether an asset will eventually be recognized. We agree that there should be no conceptual bar to recognizing costs retroactively if recognition criteria are eventually met, provided that project accounts which identify the pre-recognition costs reliably have been maintained and the use of hindsight is not required. However, if probability is removed from asset recognition criteria, it seems to us that the concept of pre-recognition costs (although not their economic reality) is thereby defined out of existence: we do not see how it is possible to capitalise costs retroactively if the definition of an asset has still not been met immediately after the costs have been incurred. If the asset did not exist at that point, those costs cannot be part of the asset.

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 is 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 historical cost derived from actual transaction prices 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 is also 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 should 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 can be an acceptable substitute for fair value in initial asset recognition situations such as business combinations, in which the historical cost of individual assets and liabilities is not determinable. This would be the case 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 cannot be a relevant initial measurement basis for the asset.

We agree that the “cost of performance” basis, as defined in paragraph 384, can 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 fair value is the measurement objective, but another measurement basis is used as a substitute, that basis should 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 may not apply.

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.*

We 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.