ERNST & YOUNG

Ernst & Young Global Limited
Becket House
1 Lambeth Palace Road
London SE1 7EU

Phone: +44 [0]20 7980 0000
Fax: +44 [0]20 7980 0275

www.ey.com

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

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Direct Line: 020 7980 0106
e-mail: dlindsell@uk.ey.com

The Technical Director
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH

Dear Sir/Madam,

Invitation to Comment - Measurement Bases for Financial Accounting - Measurement on Initial Recognition

The global organisation of Ernst & Young is pleased to respond to the above discussion paper.

We have fundamental concerns about the scope of the discussion paper, the approach followed, certain of the basic assumptions made in it, and the conclusions reached. We discuss below the principal respects in which we disagree with the paper. In view of the significance of these matters we have not addressed the specific questions for commentators listed in the discussion paper.

Ernst & Young, in common with others, has for some time been calling for the International Accounting Standards Board (IASB) to conduct a comprehensive debate on measurement bases for financial accounting as a matter of urgency in order to develop a coherent approach to measurement in IFRSs. Although the discussion paper has helped to stimulate debate on measurement, we are disappointed that the IASB has not explained how the paper relates to the programme of work it expects to undertake on measurement so as to enable commentators to frame their comments on the paper in the context of that programme of work.

In this regard we note that the agenda released by the IASB in early April implies that the Board does not expect to issue any document on the measurement phase of its Conceptual Framework project before 2009. As measurement is such a fundamental issue and is so inadequately addressed in the existing IASB Framework, we believe that this matter should be given far higher priority by the Board.

Criteria for evaluation

The analysis in the discussion paper starts with a discussion of the evaluation criteria that should be applied to each possible measurement basis and "proceeds on the basis that these criteria should be developed from, and be consistent with, the objectives of financial reporting, qualitative characteristics, and definitions of the elements of financial statements that are contained in the existing conceptual frameworks of accounting standard setters" (paragraph 29). The paper concludes that these aspects of the frameworks "narrow the rationally acceptable possibilities, but they are not sufficient, in themselves, for achieving agreement on a single measurement basis or how to choose between different bases in different circumstances" (paragraph 55). Since the existing IASB Framework makes no attempt to relate measurement to other parts of the framework but simply lists indiscriminately some of the measurement bases that are employed in financial statements, we do not believe the Framework can even be said to "narrow the rationally acceptable possibilities".

The paper points out that "existing framework objectives would appear to be capable of different interpretations in support of different measurement bases" and goes on to say that "a rigorous assessment of these competing interpretations requires reference to economic theories and evidence of user needs beyond what is specifically addressed in the ….. conceptual framework objectives and concepts" (paragraph 56). With regard to economic theories, as explained in more detail below we have significant reservations about the way the paper seeks to apply economic theory to real world assets and liabilities. With regard to evidence of user needs, we can find no reference whatever in the paper to any discussions with users of financial statements to obtain evidence of their needs or to understand how their needs might affect the selection of measurement bases.

It strikes us as very odd that, despite its conclusions regarding the inadequacy of the framework concepts as criteria for evaluating measurement bases, the paper nevertheless summarises the basis for its analysis in paragraph 65 by saying "this paper evaluates possible measurement bases against the conceptual framework criteria…". However, this statement appears to be without substance as the conceptual framework criteria are not in fact used in the paper to evaluate possible measurement bases.

Rather than using the criteria derived from the conceptual framework in order to evaluate possible measurement bases, the paper in fact uses as its criterion what it considers to be "the primary focus of financial accounting", namely "information on the amounts (value), timing and uncertainty of cash-equivalent flows" (paragraph 48). The paper argues that "since it is the cash-equivalent expectations attribute of assets and liabilities that is the primary focus of business activities, it seems appropriate to conclude that this attribute should be the primary focus of accounting measurement" (paragraph 48).

It seems to us that if the "cash-equivalent expectations attribute of assets and liabilities" is to be "the primary focus of accounting measurement", any consideration of measurement bases must have regard to the nature and purpose of different assets and liabilities in different entities, and should begin with an assessment of why different measurement bases are currently applied to different assets and liabilities. The discussion paper does not do this but instead sets out to identify the single most relevant measurement basis for all assets and liabilities, without any discussion as to why this is the only appropriate approach or even why it is appropriate at all. In this regard questions arise, for example, about the relevance (ie decision-usefulness so far as the paper is concerned) of valuing each asset and liability separately on the same measurement basis – particularly a market value basis – when the whole economic rationale for a particular business enterprise is that the cash flows are generated not by individual assets but by the unique combination of assets used in its production and delivery processes.

The closest the paper comes to considering whether different assets and liabilities should be measured differently is in its discussion of the relative merits of the market measurement and entity-specific measurement bases. Where these result in different values, the paper does raise the possibility (in paragraph 124) of using whichever measurement basis is more relevant but states that "analysis to this point does not suggest any basis for making this distinction" (paragraph 125). However, the analysis to which this statement refers provides no basis for the statement as it merely describes the differences between market and entity-specific measurement objectives and does not evaluate them in any way.

In fact, in the absence of any evaluation of the relative merits of the two approaches, the discussion in the paper provides at least as much support for the views of those who favour an entity-specific approach as it does for those who favour a market-based approach. The proposition in paragraph 128 that the market value objective is superior to an entity-specific measurement is little more than an unsubstantiated assertion, rather than, as the paper states, a conclusion that has been reached "on the basis of [the paper's] conceptual analysis". The limited "conceptual analysis" that the paper does contain in fact points to "the cash-equivalent expectations attribute of assets and liabilities" being more appropriately reflected in the measurement of cash generating units on the basis of value to the business (VTB), rather than on the basis of an exit value for individual assets and liabilities, which would in most cases be calculated based on the assumptions of a hypothetical market comprising hypothetical buyers and sellers. Indeed, the implication in the paper that entity-specific measures are non-market based is pejorative: it is often the case that a VTB measurement provides a greater indication of market conditions (and hence the "cash-equivalent expectations attribute of assets and liabilities") than is the case with many so-called exit values.

Efficient market price

The discussion paper includes lengthy discussion and analysis of market and entity-specific measurement objectives and a comparison of the two. The discussion and analysis is almost entirely based on finance literature and assumes that an "efficient market price" (unaffected by entity-specific factors) can be determined for all assets and liabilities. Indeed, the Paper refers to an "a priori expectation reasoned from the market value measurement objective … that there can be only one fair value for a particular asset or liability on a measurement date" (paragraph 135). However, in the real world few assets and liabilities are traded on active markets and therefore few assets and liabilities have real market values.

Furthermore, we have no confidence that a deductive approach to the practice of financial reporting will yield satisfactory outcomes when those deductions are based upon *a priori*, rather than *a posteriori*, premises. The paper claims (in paragraph 26) that a deductive approach will be "most useful in developing conceptual theories and hypotheses concerning the various possible measurement bases", and it expects "inductive analysis" to act as a "reality check". As no empirical evidence is cited by the paper in support of any of its conclusions, in the face of considerable evidence to the contrary and the (to us) insuperable logical difficulties inherent in its assertions, we question whether the methodology adopted by the authors has, in fact, included such a "reality check" in practice.

The paper takes this further, stating that "competitive market forces work to resolve diverse expectations of various entities' managements to a single price that impartially reflects all publicly available information…" (paragraph 128). Therefore, where there is more than one market in which an asset or liability is traded, the problem of different prices is to be dealt with by the simple expedient of "…[excluding the differences] from the determination of fair value" (paragraph 180). This assumes that it is possible firstly to identify the nature and then to quantify the effect of the particular differences that are responsible for causing the market price in a particular market to deviate from pure fair value and that when these differences are stripped away, the one fair value of similar assets or liabilities will be revealed. We do not believe this to be realistic.

Similarly, the paper goes on to presume that if a market does not exist, it is nevertheless possible to estimate reliably what the market price would be were a market to exist, which seems contradictory and illogical. Since, according to the paper, it takes "competitive market forces to resolve diverse expectations of various entities' managements to a single price….." how can there be such a single price for a particular asset or liability if there is no active market with "competitive market forces"? If there is no market, how can such a market be assumed to exist and how could anyone arrive at a single price that is reliable? In short, in the absence of a market it is a logical impossibility to be able either to identify the fair value from a range of possible options or to prove that the value selected is the "true" one.

The analysis in the paper is based solely on the premise that this "one fair value" characteristic "gives [market value] measurements a quality of comparability over time and as between entities" whereas "an entity-specific measurement … is subject to the vagaries of individual entity expectations, intentions and assumptions" (paragraph 128) and is therefore less relevant. As we believe there is neither in theory nor in practice "one fair value" that can be demonstrated logically to be such in the face of alternative fair values, we believe that the analysis in the paper is fundamentally flawed.

In our view, the conceptual analysis on which the paper is based is simplistic. It adopts a dualistic approach under which every market imperfection or inefficiency is attributed to "entity-specific" factors. However, whilst it is true that markets will tend to "work to resolve diverse expectations … to a single price", it is also the very essence of dynamic markets that new diverse expectations are constantly being created based on new information or differences in the information known to market participants. This will particularly be the case with assets and liabilities that are not actively traded because there are insufficient knowledgeable, willing buyers and willing sellers to arbitrage away price differences.

We therefore do not believe that market value measurement in practice has the qualities of reliability and relevance that the paper claims, except where there is an efficient/perfect market for the asset or liability *and* where market value measurement provides the most useful insight into the "value, timing and uncertainty of cash-equivalent flows". The items for which the efficient market and usefulness criteria are met include some financial instruments and investment properties, which are already required/permitted to be measured at market value in IFRS financial statements. As stated above, we believe that the discussion paper should have approached the subject of measurement by considering the nature and purpose of particular assets and liabilities in entities with different activities.

Fair value

Whilst the term "fair value" is seductive, as used in the paper it is a term of art and not a measurement concept as it does not identify which aspect of market-based measurement it is

attempting to capture – for example which reference market should be used, and why. Consequently, the paper's conclusion that "fair value" is superior to other measurement bases cannot be accepted until the concepts in the paper have been subject to intellectually rigorous analysis.
The Paper argues that the relevance of fair value is based on it "faithfully representing the essential properties of market value" (Summary of Part II). Since, as discussed above, we have fundamental reservations about the reliability and relevance of market value measurement in practice, it follows that we question the paper's conclusion regarding the relevance of fair value in practice. In this regard, the paper justifies its conclusion by stating that "the direct association of the relevance of fair value with the properties of market value can be seen in authoritative accounting literature supporting standards that currently require fair value measurement" (paragraph 229). The paper then refers to financial instruments and similar items by way of example. However, as efficient markets generally do exist for many financial instruments, which is not the case for most other assets and liabilities, the example of financial instruments is far from representative and therefore is not persuasive.

In our view, the whole way in which the paper handles its conceptual analysis and its analysis of alternative measurement bases is biased towards fair value. Since the paper takes the view that the objective of fair value measurement is to represent the market value of the asset or liability at the measurement date, a conclusion that the market value measurement objective is more relevant than an entity-specific measurement objective will *ipso facto* lead to the conclusion that fair value is the most relevant measurement basis. This is no more convincing than any other deductive syllogism that has an unevidenced major premise.

In this regard, as already mentioned the analysis in Chapter 4 of the paper of the market value measurement objective and entity-specific measurement objectives is not an evaluation of the relative merits of the two approaches but simply a factual analysis of each approach. No evaluation is presented that supports the paper's conclusion that the market value measure – and therefore fair value – is superior. As regards the paper's analysis of alternative measurement bases in Chapter 7, entity-specific measurement is considered in terms of differences between it and market value measurement, and not in terms of measurement bases other than market value. A conclusion that entity-specific measurement is not the way forward therefore automatically leads to the choice of market value measurement. The conceptual analysis moves on to discuss the value-affecting properties of particular assets and liabilities. This too is only addressed in terms of entity-specific measurement versus market value measurement.

Having thereby disposed of entity-specific measurement, the paper is then able to restrict its analysis of alternative measurement bases in Chapter 7 to a comparison of each basis with the fair value basis, and invokes conceptual rather than practical differences in order to show that fair value is more relevant than other bases. For example, when assessing historical cost the paper concludes that "fair value... [is] a measure of asset value received on initial recognition, [which is] missing in historical cost" (paragraph 288). This assumes that fair value – which is a conceptual construct – can be measured reliably despite the fact that the actual value given in real transactions between normally willing buyers and sellers is historical cost.

Subsequent measurement

The paper does not explain why the IASB and national standard setters decided to restrict the first stage of the project on measurement to initial recognition. The paper states only that initial recognition is important in its own right (Summary of Part I). However, the decision to consider initial recognition separately from subsequent measurement seems to assume that considerations relating to the subsequent measurement of items will have no bearing on initial measurement. This may or may not prove to be the case but should not be assumed at the outset. The paper also states that its analysis and proposed principles for measurement on initial recognition lay the foundation for subsequent stages. In view of our fundamental reservations about the paper we do not believe that it provides an appropriate foundation for subsequent stages.

In particular, we do not believe that the paper gives adequate consideration to the characteristic of relevance in relation to initial measurement. It does refer to relevance in paragraph 36 which states that financial information is relevant "when it influences the economics decision of users". However, we fail to see how measurement at fair value on initial recognition meets this criterion as only management are aware of the amount at which an asset (or liability) is initially recognised. Users of financial statements are only aware of the amounts at which assets (and liabilities) are recorded in published financial statements. Accordingly, it is doubtful whether initial recognition at fair value of itself serves any useful purpose and those who support a fair value approach may well already also have implicitly concluded that assets and liabilities should be fair valued continually, from initial recognition until final derecognition.

The reason the paper is able to restrict itself to initial recognition is that, consistent with the IASB's model, it regards financial accounting as primarily a matter of accounting for assets and liabilities rather than accounting for income and expenditure. The key difference between these two approaches in terms of financial accounting relates to the recognition of gains and losses during the period in which assets and liabilities are held. In our view it is illogical to address initial recognition separately from subsequent measurement and we believe that any discussion of measurement throughout the holding period of assets and liabilities could not dismiss historical cost as easily as does this paper. For example in our view it would be difficult to persuade preparers and users of financial statements that fair value provides more useful information than historical cost when it gives rise to an accounting but not an economic loss, as in the case of transaction costs or of inventories that are acquired for a consideration in excess of "fair value" but have a resale value in excess of cost. If, as the discussion paper says, the primary focus of financial reporting is to provide information on the amounts, timing and uncertainty of cash-equivalent flows, it is surely essential to consider the measurement of assets and liabilities throughout their entire life cycle.

If you would like to discuss our response, please contact David Lindsell at the above address or on +44 207 980 0106.

Yours faithfully

Ernst & Young