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Dear Sir

Measurement Bases for Financial Accounting: Measurement on Initial Recognition

With a membership of in excess of 37,000, the London Society of Chartered Accountants (LSCA) is the largest of the regional bodies which form the Institute of Chartered Accountants in England & Wales (ICAEW). London members, like those of the Institute as a whole, work in practice or in business. The London Society operates a wide range of specialist committees including Technical (accounting and auditing), Tax, Regulation and Ethics Review and Financial Services and Insolvency, which scrutinise and make representations to issuing bodies such as yourselves.

We welcome the opportunity to comment on the above document. We fully support the comments made and issues raised in the EFRAG and ICAEW responses and wish to make the following additional points:

Overall comment

We are strongly in favour of the fundamental review of the Framework. Addressing measurement is clearly an important part of such a review. However, before considering measurement, at least the purpose of financial statements should be determined and agreed. There is an argument, therefore, that this document has been issued prematurely. Whilst any individual paper may be useful in provoking discussion, we are also concerned that the paper is so incomplete in itself that this discussion may be necessarily deficient or misleading. It is not possible to properly consider initial measurement without also dealing with subsequent measurement. There are fundamental flaws to the rationale presented in a number of areas. We shall comment upon these flaws in the remainder of this letter. Our overriding objection to the content of the analysis presented resulted in the decision not to devote the time and resources of the Committee in responding to the individual questions.

The paper as a standalone document

Whilst we appreciate that the CASB has been allocated a discrete piece of work, we are surprised that such a lengthy paper deals solely with measurement of assets on initial recognition.

A proper examination of measurement bases, for both initial recognition and thereafter, cannot be produced without first considering the purpose of financial statements. Agreement is needed as to who financial statements are for and what the users' information needs are (including the qualitative characteristics of such information). This will allow a view to be formed as to what the elements of financial statements are and how these elements should be measured in order to provide the most useful information. This will also include considering the question of whether financial statements should record the actual transactions undertaken by companies or merely recognise and (re)measure assets and liabilities from time to time.

While consideration of fair value measurement is undoubtedly useful, if not fundamental, our view is that measurement on initial recognition cannot usefully be considered in isolation from measurement subsequently. Ongoing measurement at cost or fair value would undoubtedly influence our view of how elements should be measured when first recognised. It is rather pointless to consider one without the other.

Fair value and decision usefulness

We note that the definition of fair value is not the value that two people entering into an arm's length transaction would agree. It is a value that is not based on any individual transaction. Fair value is no more than the average of actual prices obtained in a perfect market or an attempt to determine what the average price would be if there were such a market. It does not relate to the actual conditions governing a particular transaction, such as location or relative powers of the buyer and seller or how the market for a product or service works.

It might be argued that the difference between the amount paid in an arm's length transaction and the fair value represents those things that are entity or market specific to the transaction. If this is the case we can see some merit in making explicit the difference between purchase price and fair value. Businesses sometimes find it helpful to benchmark their purchasing function against industry averages. Differences between purchase price and fair value may reflect the performance of the purchasing function in being able do better or worse than average or they may reflect the nature and location of the business and the items being purchased. For example, a small local retail business is likely to pay higher prices than a large national retail business.

There are two problems with this. In the first place it is not clear that the larger business recognising gains on initial recognition of inventory and a small business recognising losses is actually meaningful to users. The paper does not appear to be supported by research that demonstrates that fair value information is best, either theoretical or empirical.

The second issue is that the paper makes a false implicit assumption that fair value information actually exists. As we have noted, fair value is the market clearing price for a good or service. There are few, if any, completely efficient markets. Certain markets for equity securities may meet this definition. However, even when markets are free and active they are unlikely to be efficient. We suggest that for almost all goods and services an observable fair value does not exist. This means that for almost all goods and services the fair value will have to be determined in some way. Using models and estimates means that different preparers will come to different assessments about what fair value is. It is inconceivable that all preparers globally will benchmark costs against the same fair values. The usefulness of initial measurement at fair value becomes negligible if preparers do not report the same fair values.

Notwithstanding these two significant problems, we consider that there are likely to be considerable practical difficulties and costs involved in obtaining any fair value information. A robust cost-benefit analysis would be required before putting any theoretical ideas into practice.

Introducing fair value on initial recognition of assets and liabilities would change initial recognition only where fair value is different to historical cost. In our view, the paper does not sufficiently explore the reasons why such differences arise. Whilst we agree there will be entity or market specific reasons for such differences, there may be other different causes as well and the usefulness of fair value information would be enhanced if users understood why such differences from transaction prices can occur.

Presentation and performance reporting

How gains and losses on initial measurement are presented is likely to be relevant to determining whether this information is actually useful to investor decision making. Initial measurement cannot be divorced from either subsequent measurement or performance reporting. It is not possible to conclude on initial measurement in isolation. Consideration needs to be given to the decision usefulness and understandability of the movements resulting from differences between purchase price and initial fair value and between initial fair value and subsequent measurement in totality.

In the double entry bookkeeping system, assets and expenses are debits and liabilities and income are credits. The paper does not consider whether fair value on initial recognition is also relevant for income and expenses and it may be interesting to test the validity of the benchmarking notion to items that are recognised directly in income. If the fair value of a property at initial recognition is considered to be the most appropriate measure for the purchaser, why shouldn't the income statement somehow differentiate between the amount the seller receives on a sale of the property and its fair value? Would it provide useful information to give the fair value of employee services compared to what employees have been paid?

We also note that using fair value as defined on initial recognition could result in gains and losses being created that relate to fair values that have been determined based on models were not all the inputs to the model are readily available in the market. The paper does not discuss whether such gains and losses should be recognised in the income statement or whether rules would be needed to deal with these "day 1 profits".

Concluding remarks

As the paper is currently drafted we do not agree with the conclusion reached that the market value measurement objective provides superior information to entity specific measurement objectives. In our view the paper does not test this conclusion in sufficient detail nor present a convincing supporting argument. In our view, this paper does not provide a proper platform to draw conclusions about initial or subsequent measurement. Due to these limitations we are unable to conclude on the merits or otherwise of fair values. However, as we have pointed out, we have significant concerns that the information may not be useful and may be extremely costly to produce.

We hope that you have found our comments helpful. Should you wish to discuss them further please contact me at the address above or on +44 (0) 20 7220 3231.

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Yours sincerely

S. A. Brice

Steven Brice
Chair
London Society of Chartered Accountants,
Technical committee