Dutch Accounting Standards Board (The Netherlands)

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

Our ref : AdK
Direct dial : Tel.: (+31) 20 301 0391 / Fax: (+31) 20 301 0279
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Re : Comment on Discussion Paper Measurement Bases for Financial Accounting – Measurement on Initial Recognition, Prepared by staff of the Canadian Accounting Standards Board

Dear members of the Canadian Accounting Standards Board,

The Dutch Accounting Standards Board (DASB) appreciates the opportunity to respond on your draft comment letter on the CASB's Discussion Paper Measurement Bases for Financial Accounting – Measurment on Initial Recognition (DP).

We have great appreciation for your work on this topic. We believe that it is very important that these fundamental debates take place before detailed (exposure drafts of) standards are issued. We believe that the debate on measurement is one of the most important topics. Although we believe that initial measurement cannot really be separated from the debate on subsequent measurement. Nevertheless we understand your choice to limit the scope of its project, due to the complexity of the issues involved. As such we are very supportive of the debate you started.

However, we have a number of concerns regarding the reasoning and conclusions reached in the paper. This concerns have been set out below. In the appendix to this letter, we have included our responses to the detailed questions. Due to some of our fundamental concerns, we have somewhat limited our responses to the more detailed questions.

In our general response, we would like to emphasize the following:

- It seems that the DP concludes that if information is not relevant, it cannot lead to reliability. We would like to emphasize that this is not in line with the current interpretations of reliability under the Framework;

- We do not think that the issue of day-1 gains should be extended to other areas of accounting other than financial instruments;
- We do not believe that transaction costs should be taken directly into the profit and loss account. These costs are part of the investment of which it is expected that these will be realized through future economic benefits;
- We believe that the initial measurement discussion should be done in conjunction with the subsequent measurement issue. Subsequent measurement is linked to initial measurement. Example given, if subsequent measurement will be at cost, then it seems rather illogical to require initial measurement to be done on fair value;
- We have great concerns whether fair value measurements can be done with an adequate degree of reliability and that therefore the subjectivity of financial statements will increase;
- The DP seems to take the view that markets operate to a high degree of efficiency, whereas in practice this might not be the case, especially in the case of markets for non-financial instruments;
- We believe that any benefit of the respective initial measurement methods should outweigh the costs related to such methods, before such a method is applied;
- We believe that with initial measurement on fair value the principles of prudence and realization have been put aside without a full analysis of the potential consequences;
- We do not believe a cash generated unit should be used as a basis for initial measurement if an individual asset cannot be reliably valued because of a lack of information;
- The DP seems to take the view that an entity is an active market place of a huge number of transactions. The European concept of an entity is much more a combination of capital invested and labor, which may be more in line with entity-specific measurement. We believe that this different approach should be included and analyzed in the DP.

Yours sincerely,

Martin N. Hoogendoorn
Chairman DASB

APPENDIX

Responses to the questions asked in the paper

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.

DASB comment

Yes, we agree that the list is comprehensive.

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)?

DASB comment

In general we agree, although we have not analysed all of them in all detail. However, we have the following remarks:

- *For assets being constructed over a period of time we believe that cost is equal to the aggregated cost of constructing the asset, being the fair value of each consideration, instead of the fair value as when the asset becomes operational.*
- *The FASB has introduced some changes in views on value in use (non-entity specific) and has highlighted the different views there can be on fair value.*

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.

DASB comment

We agree with these sources, but believe that the value-affecting properties of assets and liabiliteis should be worked out in more detail.

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.

(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.

(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)?

<u>DASB comment</u>

We believe that the assumption of market effectiveness is included too much. Many markets, especially those for non-financial instruments are not fully efficient.

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.

<u>DASB comment</u>

We have some concern on the use of spot price as market price, irrrespective of volumes being traded. We would like to stress that the abolition of taking into account "block discounts" under IAS 39 Revised, already leads to some significant accounting issues. We would be afraid when the spot price is used as the only definition of market-based prices such issues would arise more frequently and simply not provide a true and fair view.

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.

<u>DASB comment</u>

No, we do not agree, especially since we believe that the revised definition/interpretation of reliability is inappropriate.

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.

(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.

DASB comment

No, we believe that "inefficient" markets may lead to more than one notion of fair value at any moment in time.

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.

DASB comment

We people do not disagree with including credit risk as part of initial measurement (since this will be "automatically" included in the transaction price").

However, we believe that taking into account one's own credit risk in the subsequent measurement of liabilities in the balance sheet does not necessarily provide helpful information to the users of such financial statements. Generally speaking gains arising from one's detoriated credit risk will only be realised upon default of the company. Since the general assumption for preparing financial statements is a going concern basis, we do not believe this provides useful information. We do support the disclosure in the notes to the financial statements of such fair value measurement, including one own's credit risk.

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.

DASB comment

We believe that this question should be seen as part of the discussion on which information a set of finanical statements should give the company's performance and its financial postion. We believe that without such a discussion it is rather impossible to answer the above questions.

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.

DASB comment

We refer to our comments on questions 7 and 9, in respect of the (inappropriate) assumption of efficient markets (and "one" notion of fair value) and the view that one takes on the financial statemetns.

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.

DASB comment

No, we do not agree. This is one of the topics where subsequent measurement may have a critical influence on the inclusion of transaction costs as part of the initial measurement. We do not see any reason not to include transaction costs at initial measurement when the asset is subsequently measured at cost.

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.

DASB comment

Generally we would support that once a sufficient level of reliability is achieved that relevance would be more important. However, this does not mean that fair value is by definition more relevant than cost, whereby we also refer to our earlier comment on the relationship between the balance sheet and the profit and loss statement as well as the fact that the financial statements should provide relevant information to the users of those financial statements.

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.

DASB comment

We believe that reliability should be made more operational. For example IAS 39 effectively states that only equity investment would not always be reliably measurable at fair value without providing any evidence why this would be the case.

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.

DASB comment

We believe that such a debate should much more focus on subsequent measurement than initial measurement. When an asset is subsequently measured at fair value, the measurement basis at initial recognition is rather "irrelevant". It would be relevant (e.g. have an effect on the financial reporting) in a situation when the asset is subsequently measured at cost. However especially in the latter situation (subsequent measurement at cost) it would be quite illogic to recognize any gains and losses at initial measurement, while they subsequent change in fair value will not be recognized.

However, when fair value could be measured with sufficient reliability we do not necessarily object to initial measurement at fair value. However we strongly believe that reliability is a critical condition for measurement at fair value; and in quite a lot transaction the transaction price will be the best evidence of fair value.

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.

DASB comment

We agree.

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.

DASB comment

No, we do not fully agree. We believe that the strengths of fair value are over-emphasized as well as the weakness of historic cost. We believe that the above discussion can not be completed without considering subsequent measurement.

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.

DASB comment

No, we believe when fair value cannot be reliably measured, measurement basis such as cost may be most approppropriate. Since fair value cannot be reliably measured, it will be difficult to apply these other bases as consistent as possible with the fair value measurement objective.

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 have no comment on the proposed hierarchy at this stage except to note that the discussion of the proposed hierarchy makes:

- no mention of transaction costs; and
- little reference to the discussion of the value-affecting properties.

DASB comment

We believe that transaction costs and the different views on fair values should be included as well.

DASB's other comments

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.

DASB comment

We would like to emphasize that all of our comments are in respect of transactions that have taken place on an at arm's length basis between independent parties.