Dear Sir

Your paper invites comment.

This is not a formal or full response neither is it made on behalf of my employer who may have a different view. It is simply a personal observation.

It seems that the ultimate objective as a reason for commissioning the paper is to ultimately produce a balance sheet consisting of currently valued assets and liabilities. The net of which is the owner's wealth. The movement of which is the profit or loss generated in the period since they were previously measured in the same consistent way. The profit and loss will include both changes in wealth due to normal trading operations but also changes in wealth due to changes in values of assets based on their perceived ability to generate future wealth over and above the expected future time value of money and risk.

In my view this implied objective focussing mainly on the balance sheet is fundamentally flawed and not just because it includes an element of future expectation or unearned wealth as inherent in the use of fair values.

I hope we all agree that the purpose of financial accounting is to ultimately lower the cost of capital from whatever source and whatever form it may take. The financial accounts have to provide owners/investors, lenders and other creditors, confidence and information in an objective and factual way. They must be true, fair and relevant.

I freely accept that for a company that is no longer a going concern then the balance sheet reflecting current values is far more important. For a going concern however, the accounts must fairly reflect the performance of the business and its ability to generate future cash flows to pay its creditors and realise benefit for its owners. Arguably the profit and loss account and cash flow takes on more importance than the balance sheet.

Most of the previous developments in accounting including increased governance and non financial reports, whether it was realised or not, help towards the aim of lowering cost of capital. Although in the case of Sarbannes-Oxley the cost of compliance seems to outweigh the benefit from (hopefully) lowering cost of capital.

The latest trend in trying to fair or re-value as many assets as possible is not in my view going to achieve this ultimate objective of trying to lower cost of capital. Financial accounts are in danger of becoming misleading, irrelevant and users could lose confidence as they lose understanding. Key metrics will become more volatile and volatility equates to risk. Increased risk or perceived risk requires a premium whether it be from an investor or a creditor of any kind.

I therefore have to question the papers conclusion that Fair Value, defined as being "the amount at which an asset or liability could be exchanged between knowledgeable willing parties in an arms length transaction" is the appropriate method for valuing assets or liabilities and not just at initial recognition. The further conclusion of this is that transaction costs probably have little or no value and therefore should be expensed.

It should not be forgotten that the Value of any asset (or group of assets in a company) is the ability to generate a Benefit over its Cost directly or indirectly from Consuming or owning the asset or assets.

In most cases and for businesses "Value" and "Benefit" tend to be measured in terms of a monetary amount. However the Cost of an asset is not the same as its Value. A business would not intentionally acquire assets generally if the Value (to the business) of the assets acquired was the same or less than they Cost. Cost in this case includes transaction costs or other costs required to realise the Value. Therefore owning the asset has to generate directly or indirectly a potential Benefit.

Value also depends on your viewpoint. One persons Value is another persons Cost but only at the point of sale or exchange. Any attempt to subsequently revalue the asset acquired (by reference to an external source) is irrelevant. The only relevant valuation is if its Value (to the owner) falls below its Cost (including transaction costs). If the asset is still able to potentially generate more Benefit to the Owner than will be consumed then it still has Value greater than Cost. It should not be the purpose of accounting to determine if the expected realisation of the Benefit over time exceeds so called time value of money or to consider the risk still to be taken to achieve the Benefit. Or for that matter whether its external Fair Value is less than the Cost.

It is not difficult to think of examples where the same asset can have different Values in the hands of different owners. If it was not the case then assets would never change hands. In a trade the seller is not able to generate any more Benefit from owning the asset hence the sale whereas the buyer would not buy if he was in the same position. It is also not difficult to find examples where the buyer would be willing to pay more than the seller needs for a sale. What therefore is fair value?

Therefore the only relevant valuation of the asset is the Value placed on it by the Owner. If that Value is greater than Cost including transaction costs, which it should be at the point of acquisition, then it goes against fundamental principles of accounting to recognise a profit from simply revaluing an asset. It may be an indication of a potential change in wealth at any point in time but the benefit of owning that asset has not been realised and should not be accounted for. If that Value is less than Cost then the diminution needs to be expensed. The whole point of business is for an Owner to acquire assets that he reasonably expects to create a Value greater than they Cost.

An asset owned by going concern has a different Value to one owned by a company that has ceased trading. In the latter Fair Value as defined above is appropriate. The principle of assessing the value of say a fixed asset property such as a factory as not higher than its value to the business as a going concern and not at its Fair Value if sold as an non performing asset is perfectly acceptable for accounting purposes so why should other business assets be treated any differently? Although such fixed assets are currently revalued in that way any increase in value is not a profit and is clearly identified as an unrealised gain. If we follow the conclusion of using fair values for assets then fixed assets are generally overvalued in the accounts.

The use of net present values to take into account the time value of money for the purposes of fair valuing certain assets is also not welcome. It requires the use of a discount rate which is based on an arbitrary yield curve. The time value of money is not a fact, it is actually personal to the Owner and is a consequence of values placed on assets by others and therefore not determined by reference to a yield curve. i.e. It is a circularity to use it to value assets from which the yield curve derives in the first place. It should not be the purpose of accounting to try to identify whether the increase in benefit to the Owner from one period to the next was more or less than an arbitrary view of the time value of money at a point in time.

Ultimately it is the owner's valuation that determines whether taking into account his time value of money and his required return for taking risk, whether the asset is worth owning in order to generate a benefit. Every owner will have a different requirement. It is arrogant to think that financial accounting has the ultimate answer to that problem. Financial Accounts must remain factual and objective. By definition valuation of any kind is subjective and inconsistent. It is only a fact when assets change owners as measured by historical cost and historical proceeds but only to the parties involved at that point in time.

I am not expecting or requiring an answer to this email.

Regards

STEVE IMPEY