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

The Swedish Enterprise Accounting Group (SEAG) is a forum for Chief Accountants from the largest Swedish listed companies. The Group is administered by the Confederation of Swedish Enterprise, to which most participating companies of SEAG are joined.

Representing preparers' point of view, SEAG welcomes the opportunity to comment on the above-mentioned discussion paper.

Fully endorsing the general comments made by the Unice on the Discussion Paper, we put forward some more detailed comments in this letter regarding the discussion of historical cost vs fair value, see appendix to this letter.

We believe that the strengths of fair value and the weaknesses of historical cost are overstated and the weaknesses of fair value and strengths of historical cost are understated. We do not agree that fair value should be used as measure of assets and liabilities on initial recognition, even when it can be estimated with acceptable reliability. Even if the interplay between potential parties before an arm's length transaction does not fully resolve the diverse expectations and risk preferences, the fair value of the consideration in an actual transaction does typically not differ enough from the fair value of the asset acquired or the liability incurred to motivate fair value as measure of assets and liabilities on initial recognition. If the potential parties are only two, or not a number, a fair value does by definition not exist.

We would also welcome a discussion of the reliability of in particular estimated fair values in the cases where no readily available market prices are at hand. As preparers, we are currently faced with increasing demands for control over our financial reporting through the U.S. Sarbanes-Oxley act, the Swedish Code of

Corporate Governance and similar initiatives. To introduce on a large scale a practice of estimated fair values will make the control more difficult and will introduce uncertainties as well as increased control and auditing efforts.

In a project like this, independent of its very theoretic starting point for defining and discussing measurement alternatives, a sound cost/benefit approach should have been adopted and integrated in the initial discussion paper. A discussion should have been made of the types of acquisitions where such fair values are reasonably easy available. Applied on a general basis for all cases, our opinion is that the additional costs for preparers to find or estimate fair values on many purchase transactions would by far outweigh any benefits for users of the financial statements. Should a continuation of the approach made by the Canadian paper come into being, it would necessarily have to be accompanied by realistic field tests. SEAG would in that case offer its assistance to provide an environment among its companies suitable for testing purposes.

We believe that practical consequences for how companies are to manage accounting and reporting also should be considered in standard setting, and this discussion paper is lacking this perspective.

We are pleased to be at your service in case further clarification to our comments will be needed.

Yours sincerely,

CONFEDERATION OF SWEDISH ENTERPRISE

Carl-Gustaf Burén
Secretary of the Swedish Enterprise Accounting Group

APPENDIX (SEAG answer to Discussion Paper "Measurement Bases")

This appendix contains our answers to some of the questions in the invitation to comment in the paper. In preparing these comments, we have focused almost exclusively on the condensed version of the paper. As such, when we mention a paragraph number (p.), we refer to the condensed version of the paper unless stated that it is to the main paper.

Q1. 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 possible measurement bases listed are: historical cost, current cost (reproduction cost and replacement cost), net realizable value, value in use, fair value and deprival value. Yes, we agree that the list is comprehensive.

Q2. 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 comment mainly on the historical cost as a possible basis of measurement on initial recognition, and we note that the proposed definition, in p. 34, of historical cost of an asset is the fair value of the consideration given to acquire that asset at the time of its acquisition.

Historical cost is not a fair value as defined in the paper, p. 46ff, it is true, and we note the distinction between the fair value of the consideration, p. 34, given, in acquiring an asset, or received, in incurring a liability, and the fair value being the amount for which an asset or a liability could be exchanged between knowledgeable, willing parties in an arm's length transaction and embodying the market value measurement objective, p. 46 and 48. The proposal in the paper is that the measurement basis should be described as "historical cost" only in cases where it differs from fair value, p. 122. We interpret the paper's position to be that if an entity that regards historical cost, as defined in p. 34, to be its measurement basis on initial recognition and if the cost in an acquisition does not differ from the fair value, the entity would then not be allowed to add transaction costs to the measure of an asset. In our opinion, transaction costs should be allowed to be included in the acquisition cost. See also our answer to Q11?

Nevertheless, historical cost is the fair value of the consideration in an actual exchange between two knowledgeable, willing parties in an arm's length transaction, cf. p. 129. An entity may have a higher expectation of the recoverable amount of an asset than does the market participants as a collective, p. 122, but it has on the same time a strong incentive not to give a higher consideration than necessary. And, as noted in p. 56, market participants are not under any compulsion to transact with other parties at disadvantaged prices, including that the entity is not under any compulsion to acquire the asset for a consideration above its fair value on the market, as defined in the paper.

A situation as the one described in p. 110 may of course occur, with only one potential seller and only one potential buyer, but typically the buyer meets several potential sellers, and *vice versa*. At least, in the situation, the potential seller has a strong incentive to find more potential buyers. In any case, talking about a fair value, as defined in the paper, in such a situation must be a case of contradiction.

We are concerned about how "at the time of their acquisition" is understood in the paper for a non-contractual asset that it takes time to construct. This issue also demonstrates the inherent weakness of the Discussion Paper, limiting its scope to initial recognition without commenting on subsequent re-measurement. According to p. 32 and the second paragraph of the summary, the initial recognition, when initial measurement shall take place, of such an asset is when it becomes ready to contribute to the generation of future cash flows. We believe that the historical cost of such an asset is the accumulated cost incurred in constructing it; in other words the aggregate of the fair values of each of the individual considerations actually given in all the transactions during the construction. If the initial measurement of such an asset should be determined only at the date when it becomes ready to contribute to the generation of future cash flows, and the measurement basis should be historical cost, would it mean that the historical cost of it would be the fair value <u>at that date</u> of all the considerations given to construct it?—That is *not* in our view the historical cost of such an asset, and we find it contrary to the definition of historical cost in p. 34. Further, we do not realize how it would be determined in practice. Advances in computer and information technology may enable processes of masses of data that could not have been contemplated in practice a few years ago, p. 28, but determining the amount to be recognized at the date when the asset becomes ready would not be only a matter of data processing.

Regarding a case where the initial measurement of a non-contractual asset that it takes time to construct should be determined only at the date when it becomes ready to contribute to the generation of future cash flows, and the measurement basis should be fair value, would it mean that the fair value of it should be the amounts at that date (between knowledgeable, willing parties in arm's length transactions) of all the transactions to construct it, or should it be the fair value of the ready asset? If the latter, how should all the transactions during the construction be initially recognised, and how should the re-measurement at the date when the asset became ready be recognised?—The reasoning in p. 200 of the main discussion paper seems to imply that an incomplete asset on a balance sheet date should be measured at fair value in its place and condition at the measurement date, and an appropriate estimate of that fair value is said to be made by deducting the discount that the market would require for the asset's lack of completeness from the observable fair value of an otherwise equivalent complete asset. To us, this implies re-measurement of an asset under construction at each balance sheet date, and possibly at the date when it becomes ready to contribute to the generation of future cash flows. However, we haven't found anything on the recognition of such re-measurement.

Q11. 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.

In p. 86, transaction costs are defined as incremental costs that are directly attributable to the acquisition of an asset or the issue of a liability but, for the measuring of the fair value of the asset or the liability, are not recoverable in the market place on the measurement date. (Here, we disregard from transaction costs attributable to the disposal of an asset or a liability.) Further, in p. 86, it is proposed that transaction costs, as defined, are not part of the fair value of an asset or a liability on initial recognition. Reference is made to pp. 193-200 of the main paper for further basis for this proposal. In p. 86 it is neither discussed whether such transaction costs should be part of the historical cost of an asset or a liability on initial recognition, nor how such costs should be recognised, instead of being a part of the fair value of an asset or a liability on initial recognition.

According to p. 198 in the main paper, transaction costs, as defined, incurred in acquiring an asset or issuing a liability are recognized separately as a charge to net income on initial recognition if the asset or liability is measured at fair value. It is a truism that, as a result, transaction costs do not give rise to any difference between entry and exit value under the market value measurement objective. It may be that the cost-revenue matching objective is enhanced by the measurement of assets at fair value rather than historical cost on initial recognition, p. 125 in the condensed version, but we are not convinced of that it is further enhanced by recognizing transaction costs as a charge to net income on initial recognition. At least, expensing transaction costs immediately means that they do not match with any revenue.

Further according to p. 198 in the main paper, under an entity-specific measurement objective, such as historical cost, transaction costs could be added to the measure of an asset, or deducted from the measure of a liability, on initial recognition if the entity expects that the transaction costs will be recovered from future activities involving the asset or liability. We understand such addition or reduction to be in accordance with the conventional cost-revenue matching objective, as described in p. 123 in the condensed version.

Q14. 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 note, in p. 60, that it is proposed, that the market measurement objective has important qualities that make it superior to entity-specific measurement objectives, at least on initial recognition, see also p. 102. According to p. 54, the market measurement objective is reasoned from finance literature on market prices and efficient market, and the objective is to reflect the price that would result from an open and active competitive market process. In accordance with the market value (*sic*) measurement objective, it is said in p. 53, an entity looks to market prices of assets and liabilities, which reflect market risk preferences and market expectations with respect to the amounts, timing and uncertainty of future cash flows. It is neither clear to us whether it is also reasoned from finance literature that entities actually look to such prices, nor whether entities do that generally, or in certain situations. Further according to p. 53, an entity-specific measurement objective looks to the expectations and risk preferences of management of the reporting entity. We wonder what the meaning is of an objective looking to these expectations etc.

We think that it is relevant for the reasoning here, that the predictive value of financial information is related to, that the economic decisions that are taken by users, N. B., of financial statements require an evaluation of the ability of an entity to generate cash and cash equivalents and of the timing and certainty of their generation, p. 13. It may also be relevant that a focus on cash-equivalent expectations is not intended to imply that the appropriate basis for measuring individual assets and liabilities is necessarily an exit value such as net realizable value, p. 20. The paragraph continues that the relationship between the expected cash-equivalent flows of an entity as a whole, or of business segments, and the contribution of individual assets and liabilities to those flows is a complex issue. As active in the largest Swedish listed companies, we certainly agree, and we are not convinced that the market measurement objective, as described in the former paragraph, is superior for an evaluation of the ability of an entity to generate cash etc. Further to fair value as the most relevant measure of assets and liabilities on initial recognition of assets and liabilities, it is said, in p. 48 and p. 102, that there seems to be general acceptance among accounting standard setters that the objective of fair value measurement is to represent the market value of an asset or liability at the measurement date but that traditional definitions of fair value make no mention of the market value measurement objective. As we understand p. 102, only fair value meets the market value measurement objective.

If the historical cost does not differ from the fair value, cf. p. 122, the choice between historical cost and fair value as measurement basis at initial recognition is to us only a conceptual issue. However, if the historical cost does differ from the fair value, and fair value is the measurement basis at initial recognition, the fair value of the consideration given to acquire an asset differs from the amount initially recognized of that asset. The advantage then of using fair value is mentioned in p. 124. The treatment of the difference is of course crucial to enhance the cost-revenue matching objective, as explained in p. 125. According to p. 124 together with p. 295 in the main paper, any profit or loss on acquisition, as the difference between the fair value of the asset on acquisition and the fair value of the consideration given to acquire the asset, should affect the net income immediately. Such profit or loss is said to reflect the market measure of the effectiveness of the asset acquisition or creation activity, and no expected entity-specific advantages or disadvantages are carried forward to future periods.

We do not agree that fair value should be used as measure of assets and liabilities on initial recognition, even when it can be estimated with acceptable reliability. We think that the description of historic cost, pp. 34-37, and the analysis of it, pp. 120-137, is not neutral; the strengths of fair value and weaknesses of historical cost are overstated and the weaknesses of fair value and strengths of historical cost are understated. Even if the interplay between potential parties before an arm's length transaction does not fully resolve the diverse expectations and risk preferences, cf. p. 54, the fair value of the consideration in an actual transaction does typically not differ enough from the fair value of the asset acquired or the liability incurred to motivate fair value as measure of assets and liabilities on initial recognition. If the potential parties are only two, or not a number, a fair value does by definition not exist.

We belive that initial recognition is the event where fair value has the least relevance in comparison with historical costs and also the event where adoption of a fair value requirement would cause most additional costs for preparers for very little benefit.

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