Grant Thornton International
Broad Street Office

Grant Thornton

18 April 2006

Director, Accounting Standards
Canadian Accounting Standards Board
277 Wellington Street West
Toronto
Ontario
MV5 3H2
Canada

Email: *ed.accounting@cica.org*

Discussion Paper: Measurement Bases for Financial Accounting - Measurement on Initial Recognition

Grant Thornton International is pleased to comment on the Discussion Paper *Measurement Bases for Financial Accounting - Measurement on Initial Recognition ("the Paper").*

We appreciate the work of the staff of the Canadian Accounting Standards Board ("the staff") and believe that the Paper makes a useful contribution to the ongoing debate on measurement in financial reporting. However, we are not persuaded that the Paper's scope and analytical approach provide an adequate basis for some of its conclusions and recommendations. Specifically, we believe that measurement should be considered comprehensively, including subsequent measurement. Further, the Paper approaches its subject at a highly generalised level, largely without reference to specific types of asset and liability or the circumstances in which they are recognised. Such an approach is insufficiently grounded in reality - it implicitly assumes that each measurement basis is similarly applicable to any asset or liability. This is in our view a dubious assumption.

We also find some of the Paper's arguments and conclusions unclear or inconsistent. For example, an *a priori* expectation is expressed that there can only be one fair value (at the measurement date). It is our observation that *most* goods and services, including publicly traded ones, are transacted at a range of prices - sometimes a wide range. The Paper suggests that in many cases ("common, publicly traded goods and services") it will be reasonable to assume that transaction price represents fair value. The Paper nevertheless asserts that bargain purchases and over-payments are commonplace.

:

For these reasons we largely reserve judgement on the Paper's tentative conclusions and recommendations at this time. We do however have significant doubts over the conclusion that fair value should be the preferred measurement basis for assets and liabilities in general. In particular, we believe that the use of fair values on initial recognition for assets and liabilities for which there are no observable market values derived from active markets would impose significant additional cost and complexity. We do not currently find the Paper's arguments for fair value sufficiently compelling to overcome those concerns. Moreover:

- Whilst we understand the theoretical arguments presented on the advantages of the "market measurement objective", those arguments rely upon the process by which equilibrium prices are determined in active, competitive and open markets. We do not believe these advantages can be safely extended to the majority of assets and liabilities that are not traded on such markets.

- Extending the use of fair value to other types of asset and liability will generally require the use of valuation models and techniques. A valuation performed by management (as opposed to the market) is of course entity-specific even if its objective is to predict a market price. Valuation models tend to add cost and complexity, can be difficult to understand and are often subject to serious reliability issues.

- On the subject of reliability, we note that fair value represents (or is an attempt to estimate) a single, market equilibrium price. In our view, if valuation models or techniques produce a wide range of possible fair values, serious doubt is cast over the reliability of the measurement.

- The Paper argues that "relevance" should be the primary criterion for selection of a measurement basis. "Reliability" is in effect viewed as a constraint on the use of the preferred measurement basis (fair value). We agree with this view to a point - it would clearly be inappropriate to report an irrelevant figure merely on the basis that it is reliably measurable. However, the Paper's analysis explains relevance and reliability as essentially distinct and separate considerations. We consider that they are inter-related - an accurate fair value might be more relevant than an accurate historical cost but a highly uncertain estimate might DO YOU WAN TTO TAKE THE WORD MIGHT OUT??? less relevant. in practice.

We also question are also doubtful the Paper's recommendation that current cost should generally be considered used in preference to historical cost (subject to reliable measurement). We acknowledge that current cost has the conceptual advantage of aiming to measure the amount that ought rationally to have been paid. However, using current cost on initial recognitionWe consider that requires ing preparers to assess the cost of a notional replacement or reproduction of assets they have only just acquired. This would impose cost and complexity and therefore needs to be justified. In our view, entities generally act rationally in acquiring assets and incurring liabilities, taking into account their circumstances.

In our view the Paper overstates the shortcomings of cost as a measurement basis on initial recognition. We consider that cost is usually a readily understandable, reliable measure, at least for assets and liabilities acquired or incurred in arm's length transactions. In those circumstances it is questionable that cost should be regarded as significantly "entity specific".

We also note, and the Paper acknowledges, that the consideration paid or received in an arm's length transaction will often equate to fair value. The extent to which this is the case in practice depends on precisely how fair value is defined and applied. The Paper's fair value model seems to require persuasive evidence that cost and fair value are the same. If so, the measure is described as fair value. We prefer to describe a measure derived from cost as cost. We are not convinced that the process of gathering "persuasive evidence" to demonstrate the proximity of a cost measure to a measure of fair value is justified in most circumstances.

Out OUROur current, tentative view is therefore that cost should be the preferred measure on initial recognition, at least where a consideration amount is determinable based on an arm's length transaction. In specific cases where historical cost is indeterminate, is not derived from an arm's length transaction, or there is persuasive evidence of under- or over-payment, other bases should be considered.

Going forward, we recommend that future research and analysis is targeted at:

- subsequent/reporting date measurement, followed by possible re-consideration of initial recognition;

- consideration of the applicability of alternative measurement bases to individual types of asset and liability, including costs and benefits;

- clarification of the fair value concept and how it should be determined in practice; and

- re-consideration of the understanding and role of reliability in financial reporting measurement.

These points are explained more fully in the Appendix to this letter. We have not answered all of the questions set out in the Paper, but hope that our comments address the main points in the staff's questions.

****

If you have any questions on our response, or wish us to amplify our comments, please contact our Executive Director of Global Standards, Ms April Mackenzie (april.mackenzie@gt.com or telephone +1 212 624 5428), or our Director of International Financial Reporting, Andrew Watchman (andrew.watchman@gtuk.com or telephone + 44 870 991 2721).

Yours sincerely

Barry Barber
Worldwide Director of Audit and Quality Control
Grant Thornton International

April Mackenzie
Executive Director of Global Standards
Grant Thornton International

APPENDIX

Detailed Comments on Discussion Paper: Measurement Bases for Financial Accounting - Measurement on Initial Recognition

The need to study measurement

We agree, at least in the context of IFRS, with the comment at paragraph 2 of the Condensed Version of the Discussion Paper ("CV2") that: "existing measurement standards and practices are inconsistent and a number of measurement bases remain unsettled or have been dealt with unsatisfactorily". The IASB's F*ramework for the Preparation and Presentations of Financial Statements* ("the Framework") is largely silent on the question of measurement. We believe this is a shortcoming that should be addressed as part of the IASB's and FASB's joint conceptual framework project.

Scope of project

We find it curious and somewhat unhelpful that measurement *on initial recognition* is considered separately. To the users of financial statements, reported asset and liability carrying amounts at balance sheet reporting dates are more relevant than the initial recognition amounts. The arguments set out in the Paper in fact seem to relate mainly to the relevance and reliability of alternative measurements in general. The Paper does not make any particular case for initial recognition specificities that require separate consideration.

We consider that there are specific factors that apply on initial recognition that will affect the selection of the most appropriate measurement basis. The Paper, however, largely fails to address these. In particular, where assets and liabilities have been acquired in an arm's length transaction the consideration amount represents, in our view, an objective and reliable measurement basis. However, in other circumstances such as:

- related party transactions
- donated assets
- liabilities incurred without receipt of consideration; and
- business combinations

the consideration amount may be unavailable or demonstrably less relevant. We recommend that any further work on initial recognition focuses on the specific circumstances that apply on initial recognition.

60 Broad Street
New York, NY 10004
P +1 212 624 5428
F +1 212 422 0144
W www.gti.org

Analytical approach

General

The Paper follows what is described as "deductive (top down) approach". An inductive (bottom up) approach is described primarily as a "reality check" [CV8]. We presume that what is meant by a bottom up approach is a study of:

- a consideration of the individual types of asset and liability (and the circumstances in which they fall to be recognised), and consideration of the advantages and disadvantages of alternative measurement bases being applied to them; and

- a consideration of the relevance of the information so provided by reference to its actual utility to users of financial statements.

If so, we regard the bottom up approach as a more fruitful line of enquiry. In stating this, we believe that a different assessment of the relevance of alternative measurement bases might be made for various types of asset and liability. For example the *predictive value* of a fair value measure can be expected to be higher for items that generate cash flows on a standalone basis and/or are likely to be realised in the market on which the fair value measure is based.

Costs and benefits

An approach that considers specific categories of asset and liability might also enable a more meaningful analysis of costs and benefits to be made. Although the Paper, at CV21, notes some of the challenges of balancing costs and benefits, we believe that potentially extensive change can only be justified if there are persuasive arguments that the benefits do in fact justify the costs.

We believe that in most circumstances the use of fair values for assets or liabilities other than those with the readily observable market prices would impose higher costs on preparers. To the extent that the Paper advocates the use of bases that will increase cost and complexity, a robust case needs to be made as to the benefits that will be derived.

Link with related projects

The Paper is intended to contribute to the debate on measurement largely for the purposes of informing the ongoing work on the IASB's and FASB's conceptual framework project. The Paper at CV10 to CV22, establishes criteria for evaluation of alternative bases using the existing IASB Framework, which may be amended in due course. Further, the IASB is expected presently to issue an exposure draft on the subject of fair value measurements, based on the forthcoming FASB standard. It seems likely that the forthcoming IASB ED will

60 Broad Street
New York, NY 10004
P +1 212 624 5428
F +1 212 422 0144
W www.gti.org

take a different view as to the definition of fair value and the manner in which a measurement described as a fair value measurement can be determined. The inter-relationship between these projects is not clear.

Identified measurement bases - completeness and definitions

In general, we agree with the list of identified measurement bases and the working definitions ascribed to them. However, we do have certain comments as follows:

Historical cost
The Paper's working definition deletes from the referenced IASB definition the words: "… or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalence expected to be paid to satisfy the liability…". Whilst we agree with the rationale for this deletion, it raises the question of whether "expected value" is an alternative measurement base that should be considered. As it stands, it is not entirely clear which of the identified bases could meaningfully be applied to income tax liabilities (for example) and other liabilities that do not result from an exchange transaction.

Current cost
This definition is, in our opinion, unnecessarily elaborate. It is expressed as the most economic of reproduction cost or replacement cost. Yet, the definition of replacement cost also envisages the possibility of reproduction of the asset in question where that would be the most economic means of replacing the lost productive capacity.

Fair value
We find the Paper somewhat contradictory in explaining what the staff mean by fair value. This in turn creates difficulties in assessing the arguments offered in support of fair value. We have no objection to the wording of the definition at CV46. However, that bare definition needs substantial clarification and explanation to be operational.

Using the proposed definition as it stands, the fair value of an item could be any exchange amount agreed between a third party buyer and seller. The following points should in our view be clarified:

- The Paper at CV 110 questions whether the price paid in an arm's length transaction for an asset (in this illustration a private operating subsidiary) is its fair value. The amount in question appears however to fall within the definition of fair value.

- Related to this point the Paper, in its discussion at CV 54 - 56, suggests that the market value measurement *objective* requires an observable price derived from an active market. The proposed implications of this on the

60 Broad Street
New York, NY 10004
P +1 212 624 5428
F +1 212 422 0144
W www.gti.org

(possible) use of fair value for goods and services not traded on such markets are not explained. For example, would the staff expect a fair value estimate to attempt to simulate the effect of a hypothetical market?

- The Paper at CV47 and elsewhere appears to reject the concept that fair value is an exit value. At CV68 and CV75 the Paper goes on to propose that the aggregation levels and reference market for applying fair value measurement should be based on the acquisition of the asset or liability (i.e. an entry value). We would tend to view exit values as more relevant for the prediction of future cash flows and note that this is the position in FASB's *Fair Value Measurements* ED. Moreover, the Paper's discussion begs questions as to what is intended by fair value measure even in commonplace situations such as manufactured finished goods inventory.

- The "a priori expectation" at CV62 that there can be only one fair value sits uncomfortably with the proposed definition of fair value. The Paper also acknowledges the existence of multiple markets, bid-ask spreads etc. Rather than trying to reason away the fact that identical assets are traded at a range of prices, the focus should instead be on developing a definition of fair value and an approach to which determination which will point to an acceptable amount for any one set of facts and circumstances.

General conceptual analysis

Market versus entity specific measurement objectives - relevance etc.
The main thrust of the Paper's argument is that a market based measurement objective is more relevant (better basis for assessing stewardship, more understandable, better predictive and feedback value and more comparable) than entity specific objectives. Whilst we recognise the theoretical advantages of a single, objective market value, we question whether those advantages really apply to assets and liabilities not actively traded in the type of market defined at CV55. We are less convinced as to the superior relevance of market prices for assets of the type discussed at CV 168 (non-contractual assets used in combination with other assets and inputs). As noted above, the usefulness of a fair value measure can be expected to be higher for items that generate cash flows on a standalone basis (normally financial items) or are likely to be realised in the market on which the fair value measure is based.

Somewhat simplistically, financial assets and liabilities are held for their cash flows and those cash flows are likely to be broadly independent of the holder. Market values will generally be determined based on expected cash flows; the market-based measurement is congruent with the impact on the entity. Conversely, a market-based measure is much less useful (at least in terms of predictive value) for operational assets and obligations that will be settled through performance.

60 Broad Street
New York, NY 10004
P +1 212 624 5428
F +1 212 422 0144
W www.gti.org

Operational assets do not generate cash flows and are not priced on the basis of expected cash flows.

In reality, of course, relatively few categories of non-financial asset and liability are traded on active markets. Without such markets, it is questionable if the market objective really applies. The objective relies to a significant extent on the interactions between a large number of market participants in determining an equilibrium price. There is no suggestion that markets always "get it right" and nor should there be. To the extent that the collective, competitive market-pricing *process* is regarded as advantageous in resolving diverse expectations and risk preferences [CV 54], it seems clear that the advantages do not apply to any asset or liability not subject to that process.

Value-affecting properties and market sources
We have commented above on a priori expectation that there can be only one market (fair) value for an item on any measurement date.

Reliability
We partly agree with the conceptual arguments on reliability set out at Chapter Six. The Paper recommends at CV89 that "when more than one alternative measurement basis achieves an acceptable level of reliability, the most relevant of those measurement bases should be selected". This of course then places great stress on what is meant by an acceptable level of reliability.

Reliability is in effect viewed as a constraint on the use of the preferred measurement basis (fair value). We agree it would clearly be inappropriate to report an irrelevant figure merely on the basis that it is reliably measurable. However, the Paper's analysis present relevance and reliability as essentially distinct and separate considerations. We consider that they are inter-related - an accurate fair value might be more relevant than an accurate historical cost but a highly uncertain estimate might be less relevant in practice.

Moreover, we have concerns with regard the argument at CV99 that: "a measurement basis should not be considered unreliable solely because it has a wide range of measurement uncertainty…". The Paper sets out at CV97-98 that measurement uncertainty can be addressed by disclosure to a certain extent. At least in the case of fair value, we consider that a wide range of measurement uncertainty is at least a clear indication that the measurement *may* not be reliable (since an active and efficient market would arrive at only one fair value). We are also sceptical that a range of measurement uncertainty is genuinely mitigated by disclosure concerning the uncertainty.

60 Broad Street
New York, NY 10004
P +1 212 624 5428
F +1 212 422 0144
W www.gti.org

Alternative measurement bases

We have various concerns over the Paper's application of the conceptual analysis in Chapters 4 to 6 to the identified bases at Chapter 7. These are explained in the following paragraphs.

Fair value

We have commented above on the relevance of the market value objective. As explained, we believe the manner of usage or settlement may affect the relevance of a fair value measure. Moreover, the Paper's assertions as to the superiority of fair value fail to take account of the fact that fair value as applied in the Paper includes entity specific factors (by proposing the determination of fair value based on the market and block size in which items are acquired). We therefore find the statement at CV 102 overly simplistic.

We believe there is a stronger case for the use of fair value on initial recognition *for items with observable market prices derived from sufficiently active markets*. We reiterate, however, that such prices are rarely available for most items. We also note that such observable market prices are not widely available other than for certain types of financial instrument (for which IFRS already requires use of fair value on initial recognition). Further, it seems intuitively clear that where items are traded in such markets the historical cost will in normal circumstances equate to the fair value (subject to secondary issues such as bid-ask spreads and timing differences between contract date and initial recognition).

The use of valuation models and techniques to estimate fair value, discussed at CV115, is especially problematic. The Paper broadly suggests that estimation models and techniques should be used and described as fair value when all significant inputs are market-consistent. As noted earlier, the conceptual arguments for fair value depend heavily on "competitive forces in an open and active market [that] seek to resolve the diverse expectations and risk preferences of individual market participants" [CV 54]. This process of market resolution is of course not applied in a valuation model or technique undertaken by management. The Paper seeks to address this by advocating techniques "consistent with the objective of estimating fair value" that "incorporate assumptions that market participants would make" [CV115]. We are very doubtful that this objective can truly be achieved in most circumstances. Moreover:

- the market value objective might be considered understandable, but valuation models and techniques are often complex and may require specialised knowledge both to apply and to interpret;

- the reliability limitations discussed at CV103-104 are often significant. Reflecting the inherent difficulty of predicting the effects of market behaviour, there are in many cases several established valuation models and

60 Broad Street
New York, NY 10004
P +1 212 624 5428
F +1 212 422 0144
W www.gti.org

techniques. Different techniques often yield very different results and models are of course highly sensitive to certain inputs. As explained above, we consider that a wide range of estimation uncertainty in a fair value estimate is at least a strong indicator of lack of reliability;

- the use of valuation models and techniques adds cost and complexity for preparers and auditors.

We note in passing that there are a number of standards in existing IFRS that require fair value measurements which, under the Paper's arguments, could not be described as such (e.g. measurement of certain intangible assets in a business combination).

Historical cost

We consider that the Paper obfuscates the case for historical cost by suggesting that the term should only be applied where historical cost differs from fair value [CV 122]. We suggest that this confuses the terminology with the underlying substance. If historical cost is to be presumed to equate to fair value in a wide variety of circumstances, much of the Paper's argument for change seems to amount to little more than how measurements are described. We are more interested in how they are performed.

The Paper is not specific as to when historical cost would be presumed to equate to fair value. The Paper suggests at CV 109 that the "amounts paid for common, publicly traded goods and services would normally be readily seen to be consistent with observable prices in the market". The Paper then asserts at CV 120 that "there are many cases … where significant differences between fair value and historical cost can arise".

We suggest the substance of the Paper's recommendations is difficult to evaluate without a far clearer picture as to how the staff perceive THE relationship between fair value and historical cost. In particular, in what circumstances would the staff expect preparers to use transaction amounts (however the measure so determined is described), and in what circumstances should a valuation exercise be undertaken?
In its normally-understood sense, we consider that historical cost is in most (but not all) cases:

- easily understandable;

- not significantly entity-specific (since it is most cases determined by the price in an exchange transaction with an unrelated third party);

- relatively straightforward to determine and verify; and

- reliably measurable.

60 Broad Street
New York, NY 10004
P +1 212 624 5428
F +1 212 422 0144
W www.gti.org

The Paper gives examples such as self constructed assets where complications arise with historical cost. In many such situations reliability issues are at least partly mitigated through the use of consistent and accepted approaches to cost allocation, and partly through secondary tests of carrying amount such as impairment testing and use of net realisable value. We note also that applying fair value to items such as self constructed plant and machinery and finished goods inventory is equally, if not more, problematic.

The Paper suggests that aN an historical cost measure needs to be supplemented by a test of recoverability. In practical terms, we disagree that this is necessary absent clear indications that the amount paid for an asset will not be recoverable. There is also, in our view, no reason to presume that a fair value amount will in fact be recovered.
In summary, then, we consider that the Paper tends to overstate the perceived shortcomings of historical cost in practice.

Current cost
We consider that current cost has limited applicability on initial recognition (although there is a stronger case for its wider use in subsequent measurement). In the context of initial recognition, current cost envisages replacement or reproduction of an asset that has only just been acquired. We are not persuaded that this is justified seems inin most circumstances. There are undoubtedly situations where current cost would give a materially different initial carrying amount than historical cost, but we expect these cases to be limited. .

Even where a material difference does arise, the nature of that difference needs to be considered. In the case of an obvious over-payment, there is perhaps a clear case to exclude the excess amount paid form the carrying value (noting that defining and identifying "over-payments" is unlikely to be straightforward in practice). In other scenarios, relevancet of than the cost of a notional replacement is less clear-cut. In situations such as obvious over-payments and self-constructed assets where ewith nof ouEven in those cases, we believe the relevance of the informationdaefurther aFor example, an entity might self-construct an asset and, if it were to do so again, might do so more economically due to learning effects. Nonetheless, the actual cost of construction reflected the real facts and circumstances faced by the entity.

We consider that current cost on initial recognition is likely to be worthy of consideration only in particular circumstances (such as assets acquired in a business combination, received by a way of grant/donation). . THIS BIT TO BE OK'D WITH GARY.

60 Broad Street
New York, NY 10004
P +1 212 624 5428
F +1 212 422 0144
W www.gti.org

In practice, we are very doubtful that requiring preparers to consider the cost of replacement or reproduction of assets they have only just acquired is justified or especially useful.

Synthesis and proposed hierarchy

Broadly the Paper's proposed hierarchy can be summarised:

Level 1	- fair value based or observable market prices, or - fair value based on adjusted observable market prices
Level 2	- estimated fair value based derived from valuation model
Level 3	- replacement cost; or - reproduction cost; or - historical cost
Level 4	- other (unspecified) models or techniques.

On the basis of our comments and concerns in the preceding paragraphs, our preferred approach would be to use cost where a cost amount is determinable based on an arm's length transaction. Where an arm's length cost for an individual asset is not available - for example in business combinations, non arm's length transactions and other cases where cost is indeterminate - other measurement bases should be considered.

We believe the use of fair value on initial recognition needs to be evaluated on a case-by-case basis, taking into account the associated costs and complexity and the extent to which there are consistent, generally accepted and reliable models and techniques in specific circumstances.

60 Broad Street
New York, NY 10004
P +1 212 624 5428
F +1 212 422 0144
W www.gti.org