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Our Reference: I06/02172 T05/1897
Your Reference: Measurement Bases for Financial Accounting

19 May 2006

Dear Sir

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

New South Wales Treasury welcomes the opportunity to comment on the above discussion paper prepared by the staff of the Canadian Accounting Standards Board (AcSB).

We agree that existing measurement guidance and practices are inconsistent. Current provisions on measurement in the Framework are limited and out-of-date.

Although the Financial Accounting Standards Board (FASB) has already concluded that fair value is the most relevant measurement basis and the International Accounting Standards Board (IASB) plans to issue the FASB statement as an exposure draft by the third quarter of 2006, the AcSB discussion paper is a valuable contribution to the discussion of measurement of assets and liabilities in financial reporting. Given the imminent FASB standard and proposed IASB exposure draft, it would be more relevant for stakeholders to consider the discussion paper in commenting on the IASB exposure draft and in the context of that exposure draft.

Before commenting on the specific questions related to measurement bases, we highlight the following:

1. We do not agree with limiting the scope of the paper to measurement at initial recognition. The discussion paper contains many topics that are equally relevant to re-measurement. It is difficult to consider measurement at initial recognition in isolation. The paper struggles with this as well, as evidenced by the numerous comments that a proposal is tentative or an area is outside the scope of the paper so judgment must be reserved.

2. We support the fundamental conclusion of the discussion paper that fair value is the more relevant measure and should be used where reliable. However, the paper should discuss in more detail the balance between relevant and reliable measurement as well as the balance between costs and benefits. The *Framework* at paragraph 44 points out that standard-setters in particular, as well as the preparers and users of financial reports,

should be aware of the constraint of the balance between benefit and cost. We do not feel the discussion paper sufficiently addresses this very important issue, even though the main discussion paper mentions the issue briefly at paragraphs 52-53.

Because the costs of determining fair value using the measurement bases outlined in the discussion paper may outweigh the benefits, we feel that, on initial recognition, the transaction price (e.g. historical cost) should be accepted as a proxy for fair value, unless:

a. there is evidence that it is materially different than fair value; or
b. the use of an alternative measurement basis (as proposed in the hierarchy) providing increased relevance and reliability can be justified when comparing both the cost of obtaining the alternative measurement and the risk that the alternative measurement may not be significantly more reliable because of the use of different evidence in the proposed hierarchy.

3. The proposed hierarchy at Chapter 8 of the discussion paper is different than the analysis of the FASB proposed hierarchy in Chapter 7 (based on an undated version of the FASB exposure draft) and is also different from the hierarchy in the proposed FASB Standard (FASB FVM Working Draft – Revised 3/15/06, paragraphs 24-30). These differences should be fully articulated and debated when evaluating the proposed IASB exposure draft.

4. The paper relies on a definition of fair value based on information that is now out-of-date. The latest definition (FASB FVM Working Draft – Revised 3/15/06) which is to be adopted by the IASB in its future exposure draft, results in the price used to measure fair value being an exit price. The AcSB definition (based on the existing IASB definition) expresses fair value in neutral terms, without being limited to an exit, as opposed to an entry, market price. This difference in definition impacts other parts of the AcSB discussion paper.

Our detailed comments follow and should be considered in light of the above observations.

Yours faithfully

Robert Williams
For Secretary

cc: David Boymal, Chairman, Australian Accounting Standards Board

Measurement Bases for Financial Accounting —
Measurement on Initial Recognition

Questions

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.

NSW Treasury does not agree that deprival value should be considered a possible measurement basis. As stated at paragraph 73, some consider deprival value to be a decision tree for selecting between three different measurement bases. Deprival value can be discussed but should not be classified as one of the alternatives for measurement.

Also, because "current cost" is only discussed in terms of "replacement cost" and "reproduction cost", not as a measurement base on its own, the list at paragraph 69 should reflect this by including replacement cost and reproduction cost within the heading "current cost".

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)?

In keeping with the comments above regarding "deprival value", paragraphs 94 to 96 on that topic should be relocated to the heading "Possible Combinations of Measurement Bases" at page 36 and the content therein should be amended.

Regarding "fair value", the most recent version of FASB Statement of Financial Accounting Standards on Fair Value Measurements (revised 3/15/06) refers at paragraph 5 to "the <u>price</u> that would be <u>received</u> for an asset <u>or paid</u> to transfer a liability in a transaction between market participants at the measurement date." This more recent definition would result in an exit price measurement. The discussion paper should be updated to reflect this change.

Apart from these issues, we agree with the working terms and definitions of the other identified measurement bases.

Q3. 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.

Agree.

Q4. 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.*

Yes, agree.

(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*.

Agree; however, when discussing "willing arm's length parties" at paragraph 110 of the main discussion paper, we suggest that "arm's length" should be clarified to mean independent parties.

(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)?*

Agree.

Q5. 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.*

Agree.

Q6. 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.

Agree with the proposed conclusion that the market value measurement objective is more relevant than entity-specific measurement objectives for assets and liabilities on initial recognition. However, we do not feel that the comparison at paragraph 122 of the main discussion paper adds anything to the debate. The previous discussion of market versus entity-specific measurement objectives at paragraphs 99 to 121 adequately covers the topic.

Q7. (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.

We disagree with this statement. We acknowledge that the various definitions currently proposed in the AcSB Discussion paper and the latest FASB Draft Statement on Fair Value Measurements refer to "the amount" or "the price", suggesting that there is only one amount or price. However, paragraph 136 of the main discussion paper states that the FASB's research on fair value measurement has led it to conclude that multiple markets with different prices do exist for some assets and liabilities. Therefore, we do not agree with making a categorical statement that there can be only one market (fair) value for an asset or liability on a measurement date.

Further, additional information about the FASB research should be included within this discussion paper to cover this important aspect.

(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.

Agree that further investigation is required regarding the existence of multiple markets and the nature and cause for their price differences.

Q8. 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.

Agree.

Q9. 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.

Agree.

Q10. 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 Measurement Bases for Financial Accounting — Measurement on Initial Recognition 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.*

We agree that the paper provides a reasonable analysis of market sources and their implications on initial recognition.

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.

We agree with the definition of transaction costs. However, we disagree that transaction costs are not part of the fair value of an asset or liability on initial recognition.

International Accounting Standards Board IAS 39 *Financial Instruments: Recognition and Measurement* states that for initial recognition of a financial asset or financial liability, it is measured "at its fair value plus, in the case of any financial asset or financial liability not at fair value through profit or loss, *transaction costs*…" (para 43).

The AcSB Discussion Paper has extended the IASB definition of transaction costs to include the proviso that they are not recoverable (para 195). Paragraph 198 of the main Discussion Paper states that such costs (transaction costs) could be added to the measure of an asset on initial recognition if the entity expects the costs will be recovered. However, it should be investigated why IAS 39 does not distinguish transaction costs that are recoverable from transaction costs that are not recoverable.

Q12. 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.

Agree.

Q13. 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.*

Agree.

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.

Agree; however, we note that the Financial Accounting Standards Board (FASB) has already concluded that fair value is the most relevant measurement basis and expects to issue its Statement on Fair Value Measurements by 30 June 2006. The IASB will issue the FASB Statement as an Exposure Draft soon thereafter.

Q15. 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

We feel that a single transaction exchange price *should* be accepted to be the *equivalent* of fair value unless there is persuasive evidence to the contrary. This assumes an amount or price for which an asset or liability could be exchanged between knowledgeable, willing parties in an arm's length transaction. The FASB proposed statement says at paragraph 16 that "in many situations, the transaction price will represent the fair value of the asset or liability at initial recognition".

In the situation discussed at paragraph 246 of the main discussion paper which talks about people getting bargains or paying more than fair value for goods or services, there would most likely be persuasive market evidence that the price or amount does not reflect fair value.

(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.

Agree.

Q16. Do you agree with the paper's analyses and conclusions with respect to the comparative relevance and reliability of:

(a) historical cost (see paragraphs 120-137 of the condensed version and paragraphs 281-319 of the main discussion paper);

(b) current cost - reproduction cost and replacement cost (see paragraphs 138-154 of the condensed version and paragraphs 320-361 of the main discussion paper);

(c) net realizable value (see paragraphs 155-161 of the condensed version and paragraphs 362-375 of the main discussion paper);

(d) value in use (see paragraphs 162-169 of the condensed version and paragraphs 376-392 of the main discussion paper); and

(e) 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.

Agree.

Q17. 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.

Agree.

Q18. 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 note that the levels in the AcSB Discussion Paper hierarchy differ from those in the FASB Statement. The AcSB Paper distinguishes estimates of fair value from substitutes for fair value. The FASB Statement prioritises market inputs to valuation techniques (assumptions market participants would use in making pricing decisions, ranging from observable market inputs to unobservable market inputs). The IASB will be issuing the FASB Statement unchanged as an IASB Exposure Draft and there would most likely be confusion about the inconsistent hierarchies in the two documents.

Q19. 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.

We commend the AcSB for the time and effort put into their Discussion Paper. However, from the point of view of the reader, many of the conclusions in the paper are tentative. The subject matter and timing of the paper are also an issue. The IASB is working on another project related to fair value measurement and FASB is close to issuing a Statement on Fair Value Measurement. The AcSB paper was issued in November 2005 with a six month period for comments. FASB is nearly ready to issue its Statement. The IASB will follow up with an Exposure Draft that will incorporate the FASB Statement. Because of this, there are certain parts of the AcSB paper that will need to be amended to reflect the latest IASB position.

In addition, addressing only measurement at recognition, not at recognition and subsequently, results in incompleteness. It is very difficult to discuss measurement without becoming involved in all of its stages. This resulted in several instances in the Discussion Paper where comment stops because it's related to re-measurement which is outside the scope of the Paper.

Appendix B Note on Conceptual Frameworks should be updated. In Australia, SAC 3 and SAC 4 have been replaced by the Framework and some of the information in SAC 3 and SAC 4 has not carried forward; eg B3(a) states that in the Australian framework (ie SAC 3, para 7), relevance and reliability are designated as the primary characteristics of financial information. The current Australian Framework does not make this statement. Figure 2 Definition of Assets and Liabilities provides SAC 4 definitions. The current definitions in Australia are the same as the IASB definitions.