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Dear Sir or Madam,

MEASUREMENT ON INITIAL RECOGNITION

Introduction

Thank you for the opportunity to comment on this issue. Should you require any clarification of the answers please contact Stuart Hastie. Our primary interest is as users of accounts and as an accountancy firm specialising in financial reporting issues. It was an act of folly on the part of IASB to invite opinions on measurement bases for initial recognition separately from how assets are to be measured subsequently. Accordingly the detailed questions your discussion paper posed are too narrow and not worthy of individual response. However, we are prepared to offer opinions on certain relevant issues below.

Historical cost

We consider that you have muddled a long list of measurement bases that some might think appropriate for balance sheet carrying values with the much shorter list for initial recognition, which should be headed by historical cost. The whole paper reads like an attempt to work backwards to find a theoretical justification for IASB's near universally slated business combinations proposal to expense the transaction costs of acquisitions.

If assets were initially recognised at the right time and measurement bases were defined appropriately you would find at acquisition time that historical cost, current cost, reproduction cost, replacement cost and deprival value were all the same number (with very few exceptions). It is no accident that throughout accounting history initial recognition at historical cost has been the norm because it has all the qualities that are sought. It is easily understandable, it is relevant particularly to owners who want to know what their resources have been expended on by their managers, can produce meaningful performance statements, it faithfully represents that value is not destroyed by normal transaction costs, it is neutral, objective and verifiable and it is comparable because other purchasers of inputs buy in the same markets at similar prices and incur similar transaction costs. Cost is also usually a cheap measure to obtain.

Lack of historical cost data

As the economist J.M. Keynes observed there is no such thing as a free lunch. Hence in the for-profit sector if you at first believe an asset does not have a historical cost, you probably have not thought hard enough. On closer inspection you will probably find that the cost has been lost in the cost of something else (another asset or an expense) or an asset and liability have been wrongly netted off, as is the case with many financial instruments that are allegedly supplied at zero cost. There may be cost identification problems in a small minority of cases. It would be letting the tail wag the dog if historical cost was thrown out in favour of fair value for initial recognition generally.

The answer to that small minority of cases does not appear on your list of alternatives. For assets where historical cost is not available, initial recognition should be at its estimated arms length exchange price plus normal acquisition transaction costs.

Why fair value is unsuitable for initial recognition

Your current fair value definition would lead to accounts that pretended on day 1 that value had been destroyed, precisely when management have demonstrated their confidence in the future of the business by spending cash to acquire an asset. Those costs of acquiring the asset are expected to be recovered and are proper costs in the initial carrying value of an asset. Costs of getting an asset to its present location and condition are part of the store of value in an asset held.

Your proposed accounts would not represent faithfully economic reality. Instead they would give income statements that are not a fair measure of performance. Owners might wrongly sack the managers on the basis of such defective accounts. It needs to be remembered that asset purchases tend to be lumpy, so writing off transaction costs will hit some years' results for a particular business more than others, in a way that is arbitrary and certainly not positively correlated with performance. There are industries where transaction costs are high, so the problem cannot be dismissed as immaterial. Hence fair values (on your definition for initial recognition) are not decision useful.

It will be a vast waste of resources if every time an asset is purchased effort is put into working out fair values. It would not just be a case of working out transaction costs and eliminating them, but also of trying to make a judgement on whether the purchaser has over or underpaid under their particular contract against a theoretical exchange price. No prizes for guessing what management will say, but the resulting audit costs will be astronomical. Instant profits for managements that can convince the auditor that they got a bargain, without even waiting for proof in the resale market!

Nobody wants obvious inefficiencies included in the initial carrying value of assets. However, it is not necessary to move to fair values on initial recognition to exclude them from the carrying value. Existing accounting standards for fixed assets and inventory exclude them from their definition of cost. The less obvious overpayments can wait for impairment testing on fixed assets or net realisable value write downs on current assets if they are still held at the reporting date.

A valuable role of accounting is for management to be judged on whether it can create value with the inputs that it purchases. Initial recognition is too early in the process to expense parts of the purchase price, by pretending that markets are perfect every day. A major part of management's function is to exploit real world inefficiencies in markets and performance statements should reflect their success or failure at the appropriate time. Paying above whatever the inefficient market price on the day of purchase happens to be may be rational and should not be treated as a day 1 loss in measuring the asset. A longer term view on recoverability is required to see whether management have added enough value to the inputs that they bought. We consider that marking to fair value on initial recognition will be throwing out the baby with the bath water and will cause unnecessary confusion in performance statements.

Net realisable value

Net realisable value is even less suitable for initial measurement because it creates bogus day 1 losses of two lots of transaction costs, those for the asset's acquisition (as described above) and those for its hypothetical disposal. Sale proceeds would be in a second hand market and for specialist assets might also give further bogus day 1 losses.

Yours faithfully

Disclosure Solutions Limited