The Hundred Group
of Finance Directors

**Financial Reporting Committee**

Director, Accounting Standards
Canadian Accounting Standards Board
277 Wellington Street West
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CANADA

19 May 2006

Dear Sir or Madam

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

I am pleased to submit comments of The Hundred Group of Finance Directors in the United Kingdom on the issues raised in the Discussion Paper. Our responses to your specific questions on the Discussion Paper are set out in the Appendix.

The Hundred Group represents the views of the finance directors of some 130 of the largest listed companies in the United Kingdom.

We have a number of fundamental concerns about the Discussion Paper.

**Scope**

We find it strange that the scope of the Discussion Paper is limited to the measurement of assets and liabilities on initial recognition. Measurement on initial recognition is not a particular problem in financial reporting and the Discussion Paper inevitably considers principles that are equally relevant to subsequent measurement. We believe that the Discussion Paper should have considered measurement in the context of both initial recognition and subsequent measurement because, in our view, it is not practicable to consider measurement on initial recognition in isolation.

We also believe that the Discussion Paper should have considered the effects of its proposals on performance measurement on which it is virtually silent.

**Measurement hierarchy**

The Discussion Paper proposes that all assets and liabilities should be recognised initially at fair value, wherever fair value can be measured reliably. Where it cannot, items would be measured at current cost where that can be measured reliably. Items would be measured at historical cost only as a last resort. At present, assets and liabilities are usually measured at historical cost on initial recognition (with some exceptions, such as certain financial instruments). Quite clearly, the proposals would represent a radical change from current practice.

Some commentators may contend that the proposals would affect the measurement of relatively few assets and liabilities because historical cost and fair value on initial recognition are identical in the majority of cases. However, we do not believe that this is the case. For example, in many commercial situations there is a significant lead-time between a product or service being ordered by the customer (at which time the price is usually agreed) and delivery taking place. In such situations it is quite possible that there would be a difference between historical cost and fair value on initial recognition.

We are concerned that that adjustments between historical cost and fair value could be frequent and extensive and that, consequently, any move to fair value measurement on initial recognition will significantly increase the cost of preparing financial statements. Given that many transactions are settled within one or two months, much of the additional cost will be expended in assessing the fair values of items that will never appear on a reported balance sheet.

Ultimately, the gain or loss recognised on a transaction is based on the cash that changes hands – that is fundamental double-entry bookkeeping. We accept that if a transaction has not been settled at a balance sheet date, it will be necessary to reassess its carrying amount perhaps using fair value where it is relevant and reliable. However, we see no sense in applying fair value measurement on initial recognition. If the transaction is settled immediately any difference between the fair value at the date of the transaction and the amount of cash that passes would be portrayed as some sort of valuation gain or loss. We think such valuation gains and losses would be spurious and would only serve to confuse, rather than assist, the users of financial statements.

**Why fair value?**

We are not opposed in principle to the wider use of fair value measurement, but we believe that, as with any basis of measurement, it should be used only where, firstly, it is relevant, and, secondly, if it is relevant it can be reliably estimated.

a) Relevance

We do not believe that the Discussion Paper makes a robust case for the greater relevance of fair value in comparison with historical cost. Indeed, we believe that the arguments that it does advance are flawed.

In particular, the Discussion Paper contends that fair value embodies the market's expectations of future cash flows. While this may be the case, we do not believe that this is a relevant measure for users of financial statements. On initial recognition, the fair value of an asset or liability will, at best, predict the future cash flows that may be expected to arise from the use of that asset or liability taken in isolation. In practice, the future cash flows that concern users of financial statements are those that will come from the use of group's of assets and liabilities in a production or service process. Such cash flows will depend on the value added to the individual assets and liabilities in the manufacturing or service process and cannot be predicted by their fair value on initial recognition.

We do not regard the use of fair value in measuring assets and liabilities in a business combination as a precedent for the wider use of fair value on initial recognition. Fair value is used in a business combination as a mechanism to allocate the cost of the acquisition in the absence of the historical cost to the acquirer of the individual assets and liabilities. Other than in a business combination, the historical cost of assets and liabilities in usually known and can be used to measure them on initial recognition. In short, assets and liabilities are measured at fair value in a business combination as a last resort in the absence of historical cost.

If there is a case for fair value measurement, it would seem to us to be more relevant on subsequent measurement than on initial recognition. We would still have concerns about the anticipation of future profits and the consequent conflict with the concept of prudence that seems to be conveniently overlooked by the advocates of widespread fair value measurement.

b) Reliability

Based on the Discussion Paper's own definition, fair value can only be reliably measured where there is a "market". A market is defined in the Discussion Paper as "A body of knowledgeable, willing, arm's length parties carrying out sufficiently extensive exchange transactions in an asset or liability to achieve its equilibrium price, reflecting the market expectation of earning or paying the market rate of return for commensurate risk on the measurement date".

While such markets may exist for items such as securities, currencies and commodities, they do not exist for the majority of products and services. We are concerned that the discussion Paper advocates the use of a basis of measurement that cannot be reliably measured in the majority of practical situations.

**Current cost as a substitute for fair value**

We would not welcome the use of current cost as a substitute for fair value where fair value cannot be measured reliably. Current cost accounting was permitted in the United Kingdom and other countries during the inflationary period of the 1970s and 1980s but was dropped because it was difficult for both preparers and users to understand and was often seen as either unreliable, irrelevant, or both.

**Meeting the needs of users?**

We believe that the Discussion Paper is trying to find a solution to a problem that does not exist.

From our dealings with the users of our financial statements, we are not aware that measurement on initial recognition is an issue within the user community. We certainly do not hear them clamouring for more widespread use of fair value on initial recognition or, for that matter, subsequent measurement.

**Workable in practice?**

We are concerned that the Discussion Paper puts forward a highly theoretical position without giving any consideration to the practical consequences of its proposals. We believe that this is rather naïve.

In the real world, business systems and controls are based on transactions – in many companies, millions of them. In the majority of cases, historical cost represents the amount of cash paid or received and is easy to track. Just imagine the additional effort that would be required if, for each one of those millions of transactions, it were necessary to assess the fair value of the asset or liability transferred at the date of the transaction. The systems implications of such an environment would be such that the costs would almost certainly outweigh any benefits several times over.

**Development of the conceptual framework**

We believe that the basis of measurement in financial statements should be addressed in the conceptual framework. We therefore suggest that any further work on measurement in financial statements should be conducted in the context of the joint FASB/IASB project to develop a common conceptual framework.

We are concerned that progress on the common conceptual framework is slow and that it is likely to be overtaken by proposals for new accounting standards that are based on principles that are in conflict with the existing conceptual framework. It is our perception that rather than address the difficult issues that surround the framework head on, the FASB and the IASB appear to have adopted a strategy of stealth, whereby they will introduce accounting standards that will take us further down their desired route towards, amongst other things, fair value measurement, and follow them with a conceptual framework that will be tailored to fit to those standards. We hope we are wrong.

We believe that the conceptual framework should be agreed first, as a matter of priority, and that accounting standards based on that framework should follow. Anything else would be like setting out on a journey without a map and, if this were the case, there would be a serious risk that the destination of global acceptance of a single set of accounting standards will never be reached.

Please feel free to contact me if you wish to discuss our comments on the Board's proposals.

Yours faithfully

**Ken Lever**
**Chairman**
**Hundred Group – Financial Reporting Committee**

Copy to:
Ian Mackintosh
Chairman
UK Accounting Standards Board

**Appendix**

**Question 1: Do you agree that the list of identified possible measurement bases sets out the bases that should be considered? If not, please indicate and explain any changes you would make.**

We agree with the list of possible measurement bases identified for consideration in the Discussion Paper.

**Question 2: Do you agree with the working terms and definitions, and supporting interpretations, of each of the identified measurement bases? If not, please explain what changes you would make. In particular, do you have any comments on the term "fair value" and its definition?**

We disagree with the definition of historical cost used in the Discussion Paper because it states that fair value is the basis for historical cost. We do not believe that this is the case. We believe that the definition currently used by the IASB more accurately reflects the basis on which historical cost is determined in practice, i.e. that historical cost is primarily based on cash or cash equivalents paid and that fair value is of secondary importance and is used only the absence of payments of cash or cash equivalents. To illustrate this point, we set out the respective definitions below:

*Discussion Paper – Condensed Version paragraph 34*

*"Assets are recorded at the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the fair value of the consideration received in exchange for incurring the obligations at the time they were incurred"*

*IASB Framework paragraph 100*

*"Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes) at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business"*

We prefer the IASB's definition and do not believe that the Discussion Paper presents a robust case for departing from it.

**Question 3: 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.**

**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.**

It is surely a truism that the valuation of an asset or a liability will differ depending on the information that is available to, and the assumptions made by, the valuer. However, we found that having engaged in a rather esoteric discussion of the factors that may affect measurement, the Discussion Paper didn't then relate those factors to the measurement bases that it identified as a means of selecting which of them should be used in financial statements. Perhaps this was because, except in those rare situations in which a perfect market exists, making such relationships would have led away from reliance on fair value where there is a known historical cost.

**Question 4: The paper analyses the market value measurement objective and the essential properties of market value.**

a) **Do you believe that the paper has reasonably identified the market value objective and the essential properties of market value for financial statement measurement purposes? If not, please explain why not, and what changes you would propose, or different or additional considerations that you think need to be addressed.**

b) **Do you agree with the proposed definition of "market"? 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.**

c) **Do you agree with the fair value measurement objective as proposed, and its derivation from the market value measurement objective?**

We do not disagree with the definition of the market objective: that is, "to reflect the price that would result in an open and active competitive market."

We do not disagree either with the definition of a market: that is, "A body of knowledgeable, willing, arm's length parties carrying out sufficiently extensive exchange transactions in an asset or liability to achieve its equilibrium price, reflecting the market expectation of earning or paying the market rate of return for commensurate risk on the measurement date." We do, however, believe that in reality most markets do not meet this definition and that it would sit better in an economics textbook than in an accounting standard.

We disagree with the fair value measurement objective in the context of initial recognition. Our principal concern is whether, in the context of initial recognition, an estimate of the price that would have prevailed in a perfect market is more relevant that the price that was actually paid by a company in an actual market.

**Question 5: Do you agree with the definition and discussion of entity-specific measurement objectives and their relationship to management intentions? If not, please explain why you disagree.**

We believe that the use of the fair value measurement basis on initial recognition is likely to cause greater reliance on entity-specific measurement because of the lack of active markets in many assets and liabilities.

**Question 6: Do you agree with the comparison of market and entity-specific measurement objectives 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? If not, please explain your views?**

We do not disagree in principle with the factors identified in the comparison of market and entity-specific measurement objectives. However, we think that it would appear rather naïve to suggest that these factors could justify the use of market measurement objectives as opposed to entity-specific measurement objectives in the real world of imperfect markets.

**Question 7(a): It is reasoned that there can be only one market (fair) value for an asset or liability on a measurement date. Do you agree with this conclusion? If not, please explain why you disagree.**

We agree that in the Discussion Paper's perfect world of perfect markets and using its definition of fair value there can be only one fair value for an asset or liability on a given measurement date. However, outside the world of perfect markets with perfect information this is unrealistic. For example, at any given time there will be differing views of the fair value of a parcel of land or a property because invariably different property agents will reach different conclusions.

**Question 7(b): It is proposed that differences between apparent market values for seemingly identical assets and liabilities on initial recognition may be attributable to:**

**a) differences between the value-affecting properties of assets and liabilities traded in different markets; or**
**b) entity-specific charges or credits.**

**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.**

**Do you agree with these proposals, within the caveats and discussion presented? If not, please explain why you disagree.**

We are concerned that the Discussion Paper appears to contend that assets and liabilities with different value-affecting properties are always traded in different markets. We do not consider this to be the case, e.g. identical items are frequently sold in different quantities (or "units of account") or to counterparties with different credit risk in a single market.

We contend that identical assets and liabilities with identical value-affecting properties may well be traded at different prices in the same market. We believe that the principal reason for this is that participants in the market do not have perfect knowledge. In other words, in the real world, business is not conducted in perfect markets and with perfect information. Indeed the existence of some markets is a consequence of there being imperfect information.

We do not understand what is meant by "entity-specific charges or credits" and how they are relevant in this context.

**Question 8: 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? If you do not agree, please explain the basis for your disagreement.**

We agree that this would be the case in the Discussion Paper's perfect world of perfect markets with perfect information. In reality, however, it is likely that the fair value of a liability assessed by the debtor is likely to be higher than the fair value of that liability assessed by the creditor because the debtor will make its assessment on the basis that it expects to settle the liability whereas the creditor will recognise some credit risk in its assessment of fair value.

**Question 9: 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.**
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.**

**Do you agree with these proposals within the caveats and discussion presented? If not, please explain why, and in what respects you disagree.**

We agree with these proposals as we consider that they are consistent with existing accounting standards.

**Question 10: 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. 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 would agree that, as far as is practicable, companies should make reference to the market in which the asset or liability being measured was acquired or issued. However, we would caution that, as indicated in our answer to Question 7 (b), the Discussion Paper demonstrates an unrealistic perception of the extent of disaggregation of markets for identical items.

We would add that this question is irrelevant if historical cost is used as the basis of measurement on initial recognition.

**Question 11: The paper concludes that transaction costs, as defined, are not part of the fair value of an asset or liability on initial recognition. 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 believe that all transaction costs should be reflected in the carrying value of an asset or a liability on initial recognition. We do not believe that distinction should be made between transaction costs that are “recoverable in the market place at the measurement date” and those that are not. While import duties on commodities bought for re-sale in the domestic market may well be recoverable in the market, other significant transaction costs such as stamp duty incurred on the purchases of land or buildings for use in a company’s business would not and would presumably be immediately expensed to the income statement. We do not believe that this would be appropriate as it would not be consistent with the concept of matching revenues and expenses.

**Question 12: 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? If not, please explain why you disagree, and indicate how you would settle trade-offs between the relevance and reliability of alternative measurement bases.**

In our view, relevance should take precedence, i.e. the basis of measurement which is the most relevant should be used unless it cannot be measured reliably. We believe that the relevance of the alternative bases of measuring assets and liabilities should be addressed by the Framework.

**Question 13: Do you agree with the two proposed sources of limitations on measurement reliability – estimation uncertainty and economic indeterminacy – and supporting discussion? If not, please explain your view.**

We agree with the analysis put forward by the Discussion Paper.

**Question 14: 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? If not, please explain why.**

We do not agree that fair value is the most relevant measure of assets and liabilities on initial recognition. We believe that historical cost is the most relevant measure on initial recognition. Consistent with our answer to Question 2, we believe that there is a role for fair value measurement as a last resort in situations where there is no payment of cash or cash equivalents.

**Question 15: Do you agree that fair value is not capable of reliable estimation in some common situations on initial recognition? 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 ; and**
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?**

We agree with the analysis put forward by the Discussion Paper.

**Question 16: Do you agree with the paper's analyses and conclusions with respect to the comparative relevance and reliability of:**

a) **historical cost;**
b) **current cost – reproduction cost and replacement cost;**
c) **net realisable value;**
d) **value in use; and**
e) **deprival value?**

**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.**

We disagree with the fair value measurement objective. We do not, therefore, agree with the Discussion Paper's conclusions on the comparative relevance and reliability of these alternative measurement bases as they are predicated on comparison with the fair value measurement basis.

**Question 17: 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? If not, please explain why.**

We are unable to comment as we do not agree with the fair value measurement objective in the context of initial recognition.

**Question 18: Do you agree with the proposed hierarchy for the measurement of assets and liabilities on initial recognition? If not, please explain your reasons for disagreeing and what alternatives you might propose.**

We do not agree with the proposed hierarchy for the measurement of assets and liabilities on initial recognition. We find it astonishing that historical cost, which is the most reliable basis of measurement, is treated almost as the measure of last resort.

We believe that historical cost is the most relevant measure on initial recognition. Consistent with our answer to Question 14, we believe that it is fair value that should be the measure of last resort.

**Question 19: Do you have comments on any other issues or proposals, including the proposals for further research? If so, please provide them.**

We believe that the consideration of appropriate measurement bases for use on initial recognition of assets and liabilities and on their subsequent measurement are inextricably linked. We do not, therefore, see any merit in conducting further work on measurement on initial recognition in isolation.