Director, Accounting Standards
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19 May 2006

Dear Sir

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

We have reviewed the above Discussion Paper issued in November 2005. Any references we provide to paragraph numbers are those of the condensed and not the main paper.

While we acknowledge that there is a need to have a discussion in respect of the area of accounting measurement we are not aware that measurement on initial recognition is a major issue for most preparers or other users of financial statements. Moreover, as regards the contents of the discussion paper, we have a number of major reservations around the proposals put forward which are as follows:

a) We believe that any discussion surrounding the topic of measurement needs to be a complete discussion. We note the caveat in the discussion paper that subsequent work may change the conclusions but as a general point we do not believe that you can specify the criteria for initial recognition without consideration being given to subsequent measurement.

   For example, we do not believe that you can comment on whether fair value is the most relevant measure of assets and liabilities on initial recognition without considering subsequent measurement criteria at the same time. Initial and subsequent measurement together determine the timing of the recognition of gains and losses arising on assets and liabilities. This takes the debate into the broader issue of the purpose of financial statements and, for example, performance reporting - what do the gains/losses represent and what useful performance information are they intended to reflect. Any initial measurement methodology needs to take into account what subsequently will provide the most relevant and useful information for users of the financial statements.

b) As regards the initial discussion of the possible basis of measurement, we do not agree with the approach on historical cost especially in respect of paragraph 35(c). We do not see that expected outflows (discounted if necessary) are not consistent with historic cost and, if they are inconsistent in some form of historic cost, how that alternative methodology would actually account for items such as provisions. We would also, for example, be concerned by the financial reporting and practical consequences of replacing the accumulation of historic costs by “fair value” at initial recognition. In general, if one is considering alternative measurement bases then the existing approach must be one of those considered in detail. In changing from generally accepted and understood accounting principles to radically different methodologies, the onus of proof must be on the clear superiority of any new approach on cost/benefit grounds.

The paper also suggests that the current IASB definition of fair value should be amended in respect of the definition surrounding the fair value of liabilities. The words ‘or a liability settled’ are removed to leave the definition as ‘the amount for which…a liability should be exchanged between knowledgeable, willing parties in an arm’s length transaction’. In other words it suggests a move away from the view that the fair value of a liability is the amount at which it is likely to be settled to one where the fair value is the amount at which the liability in theory could be currently transferred. This change may make the treatment of certain assets and liabilities appear more consistent. However, an issue remains over what constitutes fair value in certain circumstances and whether the amount would provide the most relevant and reliable information for users of accounts.

c) Although the paper goes on to discuss alternative measurement bases it concludes that fair value is the best measurement base but does not suggest how to overcome the problems it identifies in assessing fair values in some cases. This issue needs to be addressed first if the measurement base of choice is to be ‘fair value’.

In particular, we do not see the practical relevance of the statement that there can be only one market (fair) value for an asset or liability on a measurement date. This can only be the case from a theoretical viewpoint and assumes perfect market conditions which is not the case in reality, especially when one considers the range of countries and industries over which IFRS should be applied. In practice, even in mature economies, you can often see the same products for sale at different prices by different retailers/wholesalers in one market or valuers assign different values to the same asset.

The paper acknowledges that there could be differences in prices in different markets for identical assets and liabilities but does not appear to offer a framework for applying the ‘a priori expectation’ of a single market value in the many situations when it does not appear to be valid.

Consequently we do not agree with all of the analyses and conclusions reached principally because there is a clear favouring of fair value as a measurement base on initial recognition, without sufficiently justifying why this should be the case. Therefore, we do not see how in most situations a conclusive case is made for market value being superior to the price actually paid (or expected to be paid). We do not deny that fair value/market value measurements have a role in financial reporting but we believe that this is in specific areas not as the first option in any hierarchy of measurement criteria. As noted in the discussion paper, historic cost does involve some subjectivity where, for example, it is necessary to allocate costs. However, we do not regard these issues as being equivalent to the subjectivity in the widespread application of fair values.

d) The paper’s proposals all appear to be driving towards fair value as being the measurement base of choice. However the arguments put forward as to why this should be the case are not always convincing – specifically the conclusion in paragraph 60 that “market value” is superior to entity-specific value in terms of a measurement base on initial recognition does not appear to us to be justified.

The discussion paper would appear to be based upon "finance literature" and assumes 'efficient markets', which would suggest that the financial statement measurement being addressed is a theoretical, academic exercise and not one grounded in commercial realism and in the best interests of all users of financial statements. We believe that the comparison being made between entity specific and market value objectives is too theoretical and seems to base much of its market value objectives on the basis that companies operate in perfect market conditions – which is not the case.

Further consideration needs to be given in respect of items such as provisions which, by their very nature, should usually rely on entity-specific objectives rather than market objectives if they are really to be predictors of future cash flows. If a company holds an asset or liability that is traded on a reasonably efficient market we can see that one can make an argument that, regardless of management intentions, the asset or liability should be measured at the value in the market. However, where there is no such market and a company's future cash flows will reflect how it for example settles a liability, the hypothetical market value is of no use in financial statements, especially as a predictor of future cash flows. Entity specific measurement builds in the expected cash flows from the assets/liabilities reflecting how they will be used/settled, sometimes with information not available to the market, and is therefore usually the more relevant and reliable criteria.

The paper emphasises that underpinning reliability is "faithful representation" of the economic phenomenon that the information represents. It also emphasises that relevance is key, in terms of predictive value and feedback value. As far as companies, and we would suggest other users, are concerned this is reflected by the flow of resources that is expected to occur from the use of the asset or settlement of the liability as part of the ongoing business. It is not the amount that a company will never incur based on a hypothetical immediate transaction.

e) The paper suggests that transaction costs which are not recoverable in the market place on the measurement date should not form part of the fair value of the asset acquired or liability assumed. We do not agree with this and it is a good example of the problem we have with a totally market driven approach. In acquiring an asset, a company will incur a number of costs. For many assets the total costs incurred are not expected to be recovered immediately through the market but rather these costs will be recoverable through the use of the asset and therefore should form part of the fair value of that asset or liability. This is more in line with any cost-revenue matching objective that should be a fundamental part of financial statements. To a business the split of transaction costs and cost of the actual asset are largely irrelevant as what matters more is the total cost of the asset relative to the return on the asset.

Consequently, as a general comment, we are not certain this document takes the measurement debate much further given its limited focus on initial recognition and its clear agenda for fair value recognition.

The emphasis on fair value not historic cost for initial measurement would represent a fundamental change from current reporting and increase the complexity involved in the preparation of financial statements. Before any such change we should be clear that the benefits outweigh the costs and we do not see that this would be the case.

A more rounded and encompassing discussion on the topic of measurement would be more appropriate. This would need to consider the implications in practice for various assets/liabilities and different industries, as well as the consequences for performance reporting. We recognise that this would be a significant project.

We hope that you find our comments useful and thank you for the opportunity to be able to comment on this matter.

Yours sincerely

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DCP/CG/Reporting/Covlet Measurement Bases