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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**21 September 2006, London**
Project:	**Research Project: Measurement Objectives**
Subject:	**Discussion Paper: Measurement Bases for Financial Accounting – Measurement on Initial Recognition – Comment Letter Summary (Agenda Paper 6A)**

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

COMMENT LETTER SUMMARY

INTRODUCTION

1. To stimulate debate on measurement objectives and to obtain feedback that will assist the IASB in developing its views on measurement, the IASB published, in November 2005, the discussion paper "Measurement Bases for Financial Accounting: Measurement on Initial Recognition" (the paper) developed by staff of the Canadian Accounting Standards Board.

PURPOSE

2. This Agenda Paper summarises the comments received on the paper. This analysis begins by summarising the key messages and areas for consideration that arise from the responses. As well, this Agenda Paper proposes, at various points throughout the paper, future work that should be undertaken to build on the

proposals and what has been learned from respondents' comments. Specific comments on the questions asked in the paper are summarised in Appendix A.

3. It is expected that the views and suggestions shared by respondents to the paper's proposals will be considered, primarily, in the measurement phase of the joint IASB/FASB Conceptual Framework project. However, many of the comments also provide insights on issues applicable to other phases of the Conceptual Framework project, including the first phase on the objective of financial reporting and qualitative characteristics of decision-useful financial reporting information, and on issues applicable to standards-level projects. This analysis should also, therefore, be of interest to those working on other accounting standard setting projects.

METHODOLOGY

4. In evaluating the comments, the level of support for the proposals in the paper was considered. However, while the overall level of support provides some indication of the balance of views, more weight was placed on the arguments presented than on the absolute levels of support.

5. While this analysis is intended to be primarily factual, the summarization process itself involves subjectivity. Many respondents qualify their support of, or opposition to, particular issues to varying degrees; some are not clear in expressing their views on particular issues; and other respondents present apparently contradictory views within the same response. Often, therefore, a subjective assessment has to be made as to whether the respondent has expressed a position and, if so, what that position is. It is quite possible that different individuals analysing the same responses would classify certain individual responses in a different manner. However, the staff members believe that, although debate might arise over the classification of certain individual responses, the overall balance of views summarised in this document is representative of the responses received.

PROFILE OF RESPONDENTS

6. The paper was issued for a six-month comment period that ended on 19 May 2006. As of 25 August 2006, eighty-four comment letters have been received. As the paper was promoted only by means of websites,[1] the number and quality of many of the responses indicates a high level of interest in the measurement concepts. Many comment letters involved significant analysis and rigour and set out concerns, perspectives, arguments and questions that warrant consideration by standard setters and the international Conceptual Framework team. Some comment letters, however, were brief or declined to comment in-depth, with those respondents preferring to wait for future, specific IASB proposals on measurement, rather than to study and comment on a preliminary research paper that has not been deliberated by the IASB.[2] It is not clear whether others, too, might have chosen not to comment for this reason. Copies of all comment letters received are available on the IASB website.[3] Appendix B to this Agenda Paper lists the respondents, together with the industry and geographic classifications assigned. The tables in the next few paragraphs summarise that information.

7. Overall, there has been a strong response from financial statement preparers, accounting firms and professionals, standard setters and valuators. Committees representing the collective view of many individuals prepared many of those responses. Responses received, classified by industry, can be summarised as follows:

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[1] Staff of the Canadian Accounting Standards Board participated in three discussions held in London and Berlin during the comment period. The AcSB Chairman also participated in discussions by the European Financial Reporting Advisory Group and in a combined meeting of UNICE and the European Roundtable, both in Brussels.

[2] See more on this point under the heading, "Interaction with the IASB Agenda," below. In developing the paper, staff of the Canadian Accounting Standards Board discussed issues with the IASB and with representatives of other national accounting standards setters. However, the paper was issued as a Discussion Paper, rather than containing the preliminary views of the IASB, in order to stimulate the debate and seek input from constituents to inform the IASB in reaching its preliminary views.

[3] Comment letters can be viewed at http://www.iasb.org/current/comment_letters.asp?showPageContent=no&xml=16_235_79_24032006.htm.

Industry Classification	#	%
Financial Institutions	5	5.9
Financial Institution - Representatives	4	4.8
Financial Services	2	2.4
Financial Services - Representative	1	1.2
Insurance Representatives	2	2.4
Industry Representatives	7	8.3
Manufacturing	3	3.6
Agriculture	1	1.2
Oil and Gas	1	1.2
Utility	1	1.2
Consultant	1	1.2
Sub-total - preparers	**28**	**33.4**
Accounting Firms	7	8.3
Accounting Professionals	18	21.4
Sub-total - accounting firms and professionals	**25**	**29.7**
Standard Setters	**13**	**15.5**
Valuators	**5**	**5.9**
Individuals	**5**	**5.9**
Financial Institution Regulators	2	2.4
Securities Regulator	1	1.2
Sub-total - regulators	**3**	**3.6**
Academics	**3**	**3.6**
Actuarial Association	**1**	**1.2**
Public Sector	**1**	**1.2**
TOTAL	**84**	**100.0**

8. Notable by their absence from the industry classification are financial statement users[4] and individual securities' regulators[5]. Given the conceptual nature of the Discussion Paper, more responses from academics would have been desirable.

9. The geographic distribution is similar to that which is typical in response to other IASB documents for comment, though the number of responses from North America is low. Responses received, classified by geographical region can be summarised as follows:

[4] No comment letter was received from the CFA Institute. However, their 24 October 2005 report, "A Comprehensive Business Reporting Model: Financial Reporting for Investors," advocates that "all items in the balance sheet should be reported at fair value on a timely basis" (see page 25 of the report).

[5] One response was received from the International Organization of Securities Commissions, CL 14.

Region	#	%
Africa	2	2.4
Asia-Pacific	13	15.5
Europe[6]	48	57.1
International[7]	16	19.0
North America	5	6.0
TOTAL	**84**	**100.0**

10. Given the length of the main paper, a condensed version was prepared to assist respondents. The condensed version was an attempt to distil the major points of the main paper and included references to the main paper for those seeking a fuller understanding of the issues and bases for the proposals. Many respondents state that they referred to the main paper or had consulted the main paper on specific issues (36%). However, the majority of respondents either referred only to the condensed paper or did not state which paper they had consulted (64%).[8] Respondents' understanding of the full rational for the proposals may be affected by which document they consulted. It was clear from a number of the responses that some respondents significantly misunderstood some of the proposals and the framework for analysis, suggesting that greater clarity is needed on many issues.

11. Many respondents do not address all aspects of the proposals. The proposal that fair value is the most relevant measure of assets and liabilities on initial recognition attracted responses from 63% of respondents. Over half of respondents focused their comments only on areas or questions of concern (54%).

INTERACTION WITH IASB AGENDA

12. Several respondents recognize that work on the paper had begun before other related projects commenced, including the joint Conceptual Framework project and the Fair Value Measurement project. The majority of respondents are unclear as to how the paper fits in with these projects. A number of respondents believe that the paper should not have been undertaken until the Conceptual Framework study of objectives and qualitative characteristics, or the whole framework, has been completed. A few of those respondents who believe that the whole

6 Responses from the European region included 17 respondents from the United Kingdom (20% of total respondents), 5 from Switzerland (6%) and 4 each from France and Germany (5%).
7 "International" comprises those respondents representing multiple jurisdictions, such as the joint international responses from each of the Big 4 Accounting Firms, and other international organizations or representative bodies.
8 In some cases, it was clear from comments made by respondents that they had not studied the main paper, because the main paper addressed some of their significant concerns.

framework should have been completed first, view the paper as part of a separate project to develop standards-level material on measurement. Respondents view the need to first complete work on the framework as a fundamental need, for example the Institute of Chartered Accountants in Ireland:

> "considers changes in financial reporting should be evolutionary, rather than revolutionary. Financial reporting exists and is understood in an economic environment which cannot be expected to cope with revolutionary changes. Before a significant move to fair values is mandated, users and preparers should have an opportunity to comment on the underlying Framework, and time to become familiar with the significantly different financial reporting results shown by fair value."[CL 25]

Yet, some responses demonstrate that studying measurement issues without having first completed the framework can stimulate debate on financial reporting objectives, as a result of considering the implications of those objectives on measurement theory.

13. Several respondents question why the paper was not prepared in consultation with the IASB and FASB. These respondents recommend that the IASB focus on developing converged rather than new guidance, thereby reducing, not increasing, the number of differences between US GAAP and IFRS. The Group of 100 (Australia) expresses this view as follows:

> "In view of the IASB/FASB convergence project and the FASB's current work on fair value measurement and applying fair value measurement we are unsure of how the approach proposed in the paper is meant to interact with the objectives of the convergence project. We have the impression that this project has been overtaken by subsequent developments of the project on fair value measurement. Our preference would be to follow the IASB/FASB convergence route." [CL 73]

14. Several respondents raise concerns about the apparent inconsistencies between the proposed FASB Fair Value Measurement Statement and the paper, and question whether the IASB should be proposing a fair value measurement statement before addressing the issues raised by these differences. The New South Wales Treasury states that:

> "… 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 [on fair value measurement], 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." [CL 40]

15. A few respondents (notably two of the "big four" accounting firms) decline to comment on the paper's proposals, preferring to reserve comments on measurement issues until they see how they are addressed in IASB projects in process.

16. Some respondents recognize that the comments received on the paper will provide input into the measurement phase of the Conceptual Framework project. Many respondents encourage the IASB and FASB to hold consultations with constituents and issue documents for comment to further develop the measurement concepts, before proceeding with other standards-level projects involving fair value measurement.

17. Overall, many respondents commend the Canadian Accounting Standards Board for this important and thought-provoking work. PricewaterhouseCoopers state that, "the paper demonstrates the important role that national standard setters and others can play in the examination of new approaches to accounting issues." [CL 69] Some respondents believe the paper is a valuable contribution to the measurement discussion and has achieved its objective of initiating that discussion.

18. On the other hand, respondents who are not supportive of the paper's approach or proposals feel the paper "fails to truly open the long awaited debate." [ACTEO, AFEP& MEDEF - CL31] These respondents believe that more research is required and that there are many issues not addressed in the paper that need to be debated. They recommend that the IASB issue its own discussion paper to open the debate.

19. Regardless of whether a comprehensive debate has begun, respondents are clearly waiting to participate in an open and comprehensive discussion on all aspects of measurement.

SCOPE

20. *As a preliminary investigation, the paper focuses on essential primary issues of measurement on initial recognition, deferring the consideration of second order issues, such as implications of different measurement bases for reporting financial performance and changes in purchasing power of the monetary unit, to later stages.*[9] *As there is not a clean division between initial measurement and re-measurement, the paper explains that conclusions reached with respect to measurement on initial recognition are necessarily tentative and subject to reassessment when their potential implications for re-measurement are considered.*[10]

Addressing measurement in two phases

21. Substantially all respondents criticise restricting the paper's scope to measurement on initial recognition. These respondents claim that they could not fully assess the initial measurement proposals without also considering re-measurement. For example, respondents believe that:

> "Indeed, the subsequent measurement requirements could be considered more important. It is not clear to us that a historic fair value number for an asset or liability would be of any more use to the users of financial statements than a historic cost number." [PricewaterhouseCoopers - CL69]
>
> "We do not believe that measurement on initial recognition can be dealt with separately from subsequent measurement." Among other reasons – "Because applying market value on initial recognition would appear to be a commitment to using market value for subsequent measurement." [Conseil National de la Comptabilite - CL 79]

Underlying these criticisms may be a concern that the paper's proposals as to the relevance and reliability of fair value for measurement on initial recognition will prejudice the debate on re-measurement and is biased against a fully objective consideration of the issues.

22. On the other hand, a few respondents support the paper's rationale for addressing measurement in two stages and recognize that these proposals are to be reassessed

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9 Staff, supported by the IASB, felt that the issues of re-measurement involve a number of additional major issues that would be best left to a second phase of the project, including interaction with recognition issues – that is, when and how recognition should be given to value added or lost.

10 See the main paper, paragraph 12 and the condensed paper, paragraph 7.

for implications that arise from further analysis. For example, Syngenta International AG:

> "agree(s) with the decision to limit the scope of the paper to measurement on initial recognition. If re-measurement had been added, in our view the project scope would have been so wide that it would have been difficult to summarize the issues and proposals concisely or to comment on them. However, we have referred to subsequent measurement issues at certain points in our response, because it is difficult totally to divorce discussion of initial measurement from subsequent measurement issues." [CL 23]

23. Some respondents are of the view that measurement on initial recognition is rarely a problem in itself. Yet, many respondents raise significant issues with some measurement bases on initial recognition, particularly fair value.

24. A significant number of respondents erroneously believe that the paper advocated continuous re-measurement of assets and liabilities at fair value. While this is not the case, one possible shortfall of the paper is that it did not consider the extent to which conclusions, as to the appropriate measurement base to be used for initial recognition, might constrain the possible choices of measurement bases for re-measurement.

Financial performance and revenue recognition issues

25. Many respondents criticise the paper for not addressing financial performance (income) presentation and revenue recognition issues. They believe that issues relating to gain and loss presentation and recognition need to be addressed as part of any analysis of measurement bases.

26. The paper reasons that gains or losses arising on initial recognition are income effects, but does not address their presentation within income, given the separate IASB and FASB Financial Statement Presentation (formerly named Reporting Financial Performance) project. Many respondents would have preferred an analysis of when, where and how gains and losses arising as a result of the initial measurement proposals would be presented in financial reports.

27. Some respondents criticise the paper for not factoring in revenue recognition considerations. The paper does note, and illustrate, the importance of the interrelationship between measurement and revenue recognition, but concludes that these issues would be addressed better, in-depth in a second phase of the

project, taking into account the thinking of the IASB/FASB project in process on Revenue Recognition.

Summary

28. Many respondents prefer a more holistic approach and recommend that further consideration be given to addressing other aspects of measurement, including re-measurement.

29. Given the scope concerns raised, the key question is whether the paper is successful in identifying and usefully addressing important measurement issues. Many respondents believe that the paper is comprehensive and coherent, and follows a principle-based approach. Specifically, the Australian Accounting Standards Board noted that, "The Discussion Paper also identifies various measurement issues and constraints that need to be addressed, some of which are not widely appreciated."[CL83] However, many other respondents are suspicious that the paper is biased towards a fair value approach. With this in mind, it is notable that most respondents do address the measurement issues and proposals as presented in the paper. This demonstrates that, in spite of many respondents' concerns about the scope of the paper, these concerns do not negate the usefulness of the paper's analysis of, and respondents' comments on, measurement on initial recognition.

FUNDAMENTAL CONCERNS RAISED

30. The majority of respondents are not supportive of the paper's overall proposals regarding the relevance of fair value on initial recognition (63%), although some of these respondents support individual aspects of the proposals, and several respondents have mixed concerns (12%). Only a small minority support the paper's proposals overall (17%). The remaining respondents did not indicate their overall support of the paper (8%). Many of the unsupportive respondents strongly feel that the paper does not provide persuasive arguments and empirical evidence to convince readers of the need for such a "radical" change. A number of international preparers note that the users of their financial statements are not calling for fundamental changes or making any demands for fair value

measurements. The most commonly cited reasons for disagreeing with the paper's proposals are outlined below.

Competing philosophies of financial accounting purposes

31. *The paper follows a conceptual approach, using the objectives of financial reporting, qualitative characteristics and definitions in existing conceptual frameworks to identify, evaluate and develop possible measurement bases. Based on the conceptual framework, the primary objective assumed in the Discussion Paper for evaluating possible measurement bases is the decision-usefulness of the financial information, which includes the interrelated accounting objectives of decision making and stewardship. The paper analyses measurement objectives and uses those objectives to assess what alternative measurement bases purport to represent in order to recommend a measurement hierarchy for measuring assets and liabilities on initial recognition based on relevance and reliability.*[11]

32. Many respondents express profound concerns with the approach and basis on which the paper is reasoned and with the perceived direction of current IASB measurement standards. A significant number of respondents disagree with basic premises of the existing IASB Conceptual Framework that are the basis of accounting measurement theory. In particular, many respondents see the paper's conclusions as to the relevance of fair value on initial recognition to be a consequence of erroneously reasoning from faulty concepts of decision usefulness and predictive value.

33. Many respondents believe that the paper should have provided a clearer understanding of what an entity's statement of financial position and financial performance should portray (i.e., they desire clarification of, or disagree with, the objective of financial statements in the existing conceptual framework) <u>before</u> addressing and proposing any conclusions on measurement issues. Only then do they believe that a measurement approach can be evaluated as to whether it provides the information to meet that expectation. For example, Bundesverband deutscher Banken explains:

> "… we believe pertinent comments on the paper's conclusions regarding the appropriateness and superiority of certain measurement bases are impossible

[11] See the main paper, based on paragraphs 29 and 97.

> without a clear definition of what view of a company's financial performance and financial position its annual accounts are actually supposed to reflect. … It is therefore essential, in our view, to begin with a thorough discussion of the overarching principles that make up the framework before addressing and reaching a conclusion on aspects related to measurement. Only when these foundations have been laid will it be appropriate to publish any further standards or exposure drafts in which measurement issues play a central role. We are thinking, for example, of accounting for business combinations, the fair value measurement guidance project and revenue recognition." [CL 12]

34. Several preparers and accounting professionals from Europe, international-based organizations and Japan view accounting as a practical discipline for reporting on management's stewardship which, they argue, is founded in historical cost transaction prices. They believe that the stewardship and accountability objective has primacy and is separate to the decision usefulness objective. One of these respondents, F.Hoffmann La Roche explains the importance of this objective to measurement as follows:

> "…we insist that the stewardship/accountability aspects of financial reporting warrant much deeper reflection than the DP [the paper] has had the time and space to give them and that such reflection would result in less support for the fair value conclusions arrived at."
>
> "…decisions about measurement bases have as great an effect on the stewardship and accountability objective of financial statements as they do on the decision-usefulness objective. Management and shareholders have a stewardship 'contract', and financial statements have always been one main tool by which management performance has been assessed. The measurement bases used in financial statements effectively determine what management is accountable for in respect of the items reported in financial statements". [CL 41]

There is acceptance by many within this group of fair value for financial instruments when there are observable market prices, but they believe that fair value has no place in measuring assets that are to be used in the production of goods or services.

35. These respondents' views on specific issues, for example, entity-specific versus market measurement objectives, entry versus exit values, relevance and reliability are strongly affected by these fundamental differences with respect to underlying accounting objectives. As these respondents believe that the objectives of financial reporting are fundamental conceptual underpinnings for properly addressing measurement issues, these respondents fear that their concerns and arguments are being swept aside without adequate study and debate. They believe that full

consideration of these financial reporting concepts is required for a study of measurement bases to be objective and complete.

36. The paper's conceptual approach to measurement bases has served to draw out these issues and arguments, and responses to the specific questions posed in the paper need to be understood and addressed in the context of respondents' views as to the purposes of financial accounting measurement.

37. Several respondents also believe that the paper should have examined capital maintenance concepts and their implications in more depth, including their effect on income recognition.

38. Several respondents also stress the need to involve users in evaluating the informational value of the different measurement bases in order to identify what information is more useful to users and understand how it will be used by users.

Interpretation of relevance and reliability

39. *To evaluate the identified measurement bases, the paper: first - assesses the relevance of identified measurement bases, putting aside (i.e. suspending judgment on) reliability; second - considers the factors that affect reliability; and third - compares the relevance and reliability of the alternative measurement bases to develop its measurement proposal. Thus, the distinction between relevance and reliability is crucial to the paper's logic.*[12]

40. Many respondents do not clearly distinguish relevance and reliability and, as a consequence, do not clearly distinguish the relevance and reliability analysis and conclusions of the paper. A number of responses argue that fair value is not relevant, but their arguments seem to be based on perceptions of lack of reliability. Some perceive relevance and reliability to be interdependent. For example, many argue that, fair value is not relevant if there is not a directly observable market price, a reliable measurement. Some seem to use the terms almost interchangeably.

41. Other respondents seem to interpret the terms differently. Several respondents do not consider any distinct differences between the relevance of different

[12] See the main paper, based on paragraph 97.

measurement bases and believe that all measurement bases should be considered in arriving at a reliable "fair" value (some seem to see this as meaning "equitable" value). For example, one respondent argues that the effect of market forces in reducing the diverse expectations of the various participants to a single price on a measurement date is purely a matter of reliability (providing greater assurance of its "value") but that this does not make it a more relevant measurement. However, other respondents do not consider reliability constraints. Certain valuators seem to be of view that it is always possible to estimate fair (market) value—one notes that "when accounting standard setters are clear on what relevant measure of value is, valuations will be provided on that basis". [Royal Institution of Chartered Surveyors – CL18] Several other respondents do not agree that arbitrary allocations limit reliability, arguing that cost allocation is not unreliable if the "formula" is disclosed.

42. Many respondents believe that the paper promoted relevance over reliability and therefore presents an unbalanced view. Several respondents believe that the paper's interpretation of reliability is not in line with current interpretations of how trade-offs are assessed following the existing conceptual frameworks. The paper does not claim relevance to be of more importance then reliability; rather the paper tries to present both relevance and reliability as being necessary to measurement. However, the paper proposes that, if sufficient reliability is present, then the most relevant measure should be chosen.

43. *[Deleted]*

What does or should fair value purport to represent?

44. *The objective of fair value, as reasoned in the paper, is to reflect the market value of an asset or liability on the measurement date. Market value is the price resulting from an open and competitive market process that equates supply and demand, and thereby encompasses the market risk preferences and market expectations with respect to the amounts, timing and uncertainty of future cash flows. When there is no observable market price for assets or liabilities, the objective is to estimate what the market price would be if a market existed.*[13]

45. The responses indicate some fundamental disagreements and uncertainties with respect to what "fair value" is and what it should purport to represent – which is at the basis of its claim to relevance. On the surface, a majority of respondents (53%) agree with the paper that the objective of fair value should be to reflect market value. But this apparent agreement is deceptive, because there is no firm agreement on what should be accepted to represent market value.

46. Those who do not accept the market value objective do not clearly define an alternative. However, some interpret the IASB and paper definitions of "fair value" as the amount of any transaction between willing, arm's length parties (including transaction costs), irrespective of the existence of any market. Some would factor in entity expectations in some situations, i.e., they do not accept the distinctions between market value and entity-specific measurement objectives proposed in the paper (which are based on FASB CON 7).

47. Responses from three prominent property and business valuation associations raise questions as to what "fair value" is intended to represent in accounting and set out a number of perceived differences and uncertainties between "fair value" and "market value". They seem to view "fair value" as encompassing a number of the other measurement bases. The Royal Institution of Chartered Surveyors explains that, in the view of property valuers: "Fair value is a generic concept that encompasses market value. Market value is a basis of valuation/measurement." [CL18] Another association questions why accounting clings to the term "fair value" if the objective is to estimate market value. *[Remainder of paragraph deleted]*

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13 See the main paper, paragraphs 107 and 111.

48. To communicate the concept more clearly, a few other respondents also recommend revising the "fair" value term to "market" value, or explicitly stating the market principle in the definition. Respondents suggest that such clarity and a use of "plain" English would avoid complexity in accounting and reduce misunderstandings of commonly used terms.

49. One of the major issues in the paper is whether fair value should be defined as an exit value, as is to be required by the FASB Fair Value Measurement Standard and as is to be proposed in an upcoming IASB Discussion Paper, or whether the concepts of entry and exit value are irrelevant to the fair value measurement objective as is proposed in the paper. This issue was not directly addressed by many respondents. Some responses indicate a preference for the FASB definition over that of the paper, but without any supporting reasons apart from the goal of international convergence (17%). On the other hand, some respondents (23%) agree 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. For example, two comments in answer to Question 10:

> "We agree that if an entity acquires or creates an asset or incurs a liability in an exchange transaction in a market, that market is the best source for the measurement amount of the asset or liability on initial recognition.
>
> …We do not support using the markets in which the items are normally sold … because that would usually result in inconsistent measurement of items acquired in transactions with different structures – a recognition problem in modern accounting. …" [Syngenta (Switzerland) – CL 23]
>
> "We agree with the initial analysis put forward in the paper and additionally agree that more research is needed into multiple markets and their implications on initial recognition." [Accounting Standards Board (UK) – CL35]

This latter response notes a connection with the "multiple markets" issue (the subject of question 7). Many respondents address this issue in terms of whether there may be separate different exit and entry markets for the same asset or liability.

50. Some respondents agree with the proposal that conceptually there can be only one market for an asset or liability on initial recognition. For example:

> "We agree that conceptually there can be only one Market Value for an asset or a liability on a measurement date on the basis of a given set of assumptions. We endorse the observation in para 134 that it is fundamentally inconsistent with a open and competitive market for there to be any sustainable difference

> between entry and exit prices. However, in practice an asset can have more than one Market Value on a given date depending upon the assumptions made about how the asset is to be transferred, the state in which it is transferred or any other conditions that may attach to the sale. Variations in these factors, identified in the paper as 'value-affecting properties' will have impact on the Market Value." [International Valuation Standards Committee – CL 19]

This response makes this additional comment in response to Question 10:

> "We agree that the paper provides a reasonable analysis of the possible effects that different circumstances may have on the market value of a particular asset or portfolio, although we would argue that in many cases these are not different markets as such but different assumptions about how the asset is to be presented to the market."

51. On the other hand, many respondents believe there often is more than one market with different prices for assets or liabilities that are identical to the asset or liability being measured on a measurement date. For example:

> "… we consider there are many situations where different investors will have access to different markets. For example, financial institutions buying and selling derivative positions will be able to operate in both the wholesale and retail derivatives markets and therefore we believe it is important that these institutions are able to price their positions in the most advantageous market to which they have access. We are pleased to see that the paper goes on to suggest that research by other accounting standard setters has demonstrated that multiple markets can exist for some assets and liabilities which are not related to value-affecting or entity specific differences and that it is proposed that further in depth study is carried out in this area. ISDA would be pleased to support the AcSB with this work." [International Swaps and Derivatives Association, Inc – CL 32]

52. It is evident that respondents have different ideas as to what is a separate market, and make different assumptions as to the properties of an asset or liability and with respect to the position and conditions of an entity that may affect the market value of an asset or liability. For example:

- Some respondents confuse wide ranges of market prices (wide bid-asked spreads) within a market with multiple markets.
- A few respondents refer to "block discounts" as evidence of more than one market for identical assets on a measurement date. [The paper reasons that these are markets for different assets - that a large block of shares, or a large volume of an asset, represents a different unit of account with possibly different value-affecting properties than a small block or an individual unit of an asset.]

- A number of respondents reason that the situation of an entity (for example, its expertise, its intangibles such as its customer base, or its having assembled a revenue-generating operation to use assets to produce goods or services for sale) can effectively result in a more advantageous exit market price for a particular asset or liability on its initial recognition than its input market price. The implications of these value-affecting sources for the measurement of assets and liabilities on initial recognition were not fully addressed in the paper, and require consideration in relation to principles for the recognition of revenue (or more precisely for when value should be considered to be added and therefore measured in financial statements).

53. The bottom line is that respondents have different ideas as to what fair value is supposed to represent, and many seem to have a poor understanding of competing concepts. As a result, respondent support drops from 53% for the market measurement objective to 20% for the selection of fair value as the most relevant measure on initial recognition. *[Remainder of paragraph deleted]*

Does one size fit all?

54. *Implicit with the paper's approach is that the proposals are to be applied to all assets and liabilities on initial recognition.*

55. Many respondents raise concerns with the application of the proposals to certain types of assets or liabilities. These respondents feel that the paper should have separately considered financial and non-financial assets and liabilities. Several respondents also raise this concern by reference to applying the proposals to self-constructed or unique assets for which there is no active market. This preference reflects respondents' acceptance of the relevance of fair value on the initial recognition of financial instruments that are actively traded in deep and liquid markets. But a number of respondents, particularly some banks, recommend historical cost for many financial instruments that are not actively traded. One variation of this view is explained by HSBC Holdings in the following comment:

> "We believe that 'fair value' does provide relevant and objective information for certain types of transaction, particularly where financial instruments are traded for short term price performance in deep and liquid markets and the position held is representative of normal market size. The effort taken in such financial services activities to ensure that the market and non-market observable inputs to valuation models, and the models themselves, remain

> robust and valid, demonstrate that this is a complex area, critically dependent on the availability of reliable information.
>
> There are, however, many types of transaction for which deep and liquid markets do not exist, and this is happening increasingly as products are structured to meet the needs bespoke of counterparties. There is therefore a lack of sufficient market transaction data on which to base 'fair values'. While there are many significant examples in financial service business, we believe that this is a point of general relevance to most business activities." [CL 81]

56. HSBC's concern regarding the relevance of applying a fair value measurement approach to most business activities is shared by many respondents. For this reason, a significant majority of respondents strongly support historical cost (transaction amount including transaction costs) on initial recognition of assets and liabilities that are to be used in the production of goods or services, or assets that are acquired in wholesale markets for sale by retailers. This position follows generally from the stewardship view of accounting purpose held by many European, international and Japanese preparers and accounting professionals and other international respondents and standard setters, which comprise a significant proportion of respondents to the paper (27%).

57. The Accounting Standards Board of Japan sets out its "fundamental view on the measurement of assets and liabilities," in which it explains the distinction it makes between financial and non-financial assets and liabilities, and the significance of this distinction for measurement:

> "We classify assets and liabilities into financial investments and non-financial (business) investments according to the purpose of the investments….
>
> Non-financial investments such as property, plant and equipment, and inventories, are investments for which disposals are constrained by business objectives and that are aimed at obtaining the results through operating the business. In the case of non-financial investments, the result that should be compared with the ex ante expectation is obtention of cash or its equivalent through operating the business, not changes in the market price. Therefore, recognition of profit or loss should be based on that fact, not on marked to market measurement. For example, an item of property, plant and equipment is measured at historical cost less accumulated depreciation, and profit or loss is calculated based on such measurement.
>
> On the other hand, financial instruments such as securities held for trading and derivatives are investments for which disposals are not constrained by business objectives and that are aimed at obtaining gains from changes in the market price. In the case of financial investments, the result that should be compared with the ex ante expectation is a change in the market price."[CL33]

58. A few other respondents also recommend the need to consider measurement issues specific to certain industries and the implications of the proposals across different industries.

Interpretation of the market concept

59. *The paper defines a market 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.*[14]

60. A majority of respondents criticize the paper's concept of "market", believing the paper to be advocating finance and capital market theories of a "perfect" and "fully efficient" market, and not considering "commercial realism" and practice. Several respondents even refer to how "the very existence of many businesses is based on market imperfections" [for example, Austrian Financial Reporting and Auditing Committee – CL11].

61. A majority of respondents focus on how a single "equilibrium price" does not reflect the business world today, as such a perfect and complete market does not exist for many common assets and liabilities, even for many financial assets and liabilities. They note that such markets are extremely rare, and that holding fair value to that test would result in fair value being rarely capable of reliable estimation. From their experience, respondents state that goods and services are normally transacted at a range of prices, not a consistent observable price. These respondents recommend that more research and analysis be done to assess the implications of the range of market prices and their effect on the paper's proposals.

62. The paper does not intend to define the market value objective as the measure that would be attained only in a "perfect" or "fully efficient" market. The paper reasons that fair value derives its unique attributes, and claim to relevance, from its determination by market forces. This does not require perfect or fully efficient markets. The paper proposes that it is necessary to examine and define how

[14] See the main paper, paragraph 107.

market forces work in order to define fair value. *[Remainder of paragraph deleted]*

The case for historical cost on initial recognition

63. *The paper proposes that in Level 3 of the hierarchy, when the current cost of an asset or current consideration of a liability cannot be reliably estimated or reasonably expected to be recoverable or represent the amount payable, that historical cost is an acceptable substitute.*[15]

64. There is strong support from many respondents for the primary use of historical cost (transaction amount including transaction costs) to measure assets and liabilities on initial recognition. As referred to elsewhere in this comment letter summary, a common argument is that the historical cost on initial recognition in these circumstances should be viewed as to whether it can be recovered through the entity's business operations, rather than through sale. This expectation could be from the market or entity perspective at the business unit level of account, although most proponents argue for using entity management's expectations.

65. Many respondents prefer the use of historical cost on initial recognition as it is the actual amount of cash paid or consideration exchanged. They believe historical cost is an acceptable proxy for fair value—not just in rare circumstances. These respondents view historical cost bases as understandable, neutral, objective, verifiable and inexpensive to obtain, and believe that it is better linked to a stewardship/accountability objective. Historical cost information, they argue, provides relevant information about the use of cash that users need to assess management's stewardship and is a better base for projecting future cash flows (perhaps, because they believe that historical cost has more predictable effects on future income than fair value, which is viewed as being volatile?).

66. Also, many respondents support historical cost from a practical perspective, as Mazars explains:

> "…surely such a time consuming and expensive approach measuring initial values of assets and liabilities cannot be the best way to proceed. Hence, we consider that a historical cost approach (except where we have assets which are traded in an active market when fair value can be ascertained) to be both a

[15] See the main paper, paragraph 432.

superior and easier option than the fair value approach advocated in the discussion paper".[CL55]

67. Several respondents recommend that historical cost should be a presumptive requirement for fair value at initial recognition. For example, while Norsk RegnskapsStifelse feels it is important to clarify what constitutes a market, "in reality, even if there is not persuasive evidence that a single exchange price would be equal to fair value, the transaction price paid or received could be assumed to be a reasonable approximation or a reasonable representation of fair value at initial recognition."[CL42] Other respondents see fair value as a possible substitute for historical cost on initial recognition in situations in which the historical cost of an asset or liability cannot be observed, for example, in business combinations or other basket purchases.

68. Many respondents believe that the paper did not adequately consider the strengths, yet over emphasized the weaknesses, of historical cost on initial recognition. These respondents believe an unbiased assessment is needed. *[Remainder of paragraph deleted]*

Interpretation and preference for entity-specific measurement objectives

69. *An entity-specific measurement objective looks to the expectations and risk preferences of management to assess the value of an asset or liability to the reporting entity by reflecting an entity's assumptions and intentions.*[16]

70. Respondents' comments indicate that the term "entity specific" is open to some different interpretations from that set out above.[17] In particular, a number of respondents seem to be interpreting the term to encompass the unique aspects of an entity and its situation, which may affect both the entity's and the market's expectations and measurement of a particular asset or liability. The result is that it is difficult to be sure of the position of some respondents on the measurement objective issue – whether, for example, a respondent's support for the "entity-specific" measurement objective is support for taking into account the unique aspects of an entity's situation or business or for reflecting entity management's

[16] See the main paper, paragraph 99.

[17] The term and its definition were taken from FASB CON 7, which used the term "entity-specific measurement", which it explained "… substitutes the entity's assumptions for those that the marketplace participants would make" (FASB CON 7, paragraph 24b).

expectations. In retrospect, the paper probably should simply have used the term "entity expectations".

71. However, it is clear that many respondents believe, contrary to the analysis and proposals of the paper, that measurements reflecting entity expectations have greater relevance for many assets and liabilities on initial recognition than market value (reflecting market expectations). The more common arguments are reflected in the following comments:

- "We believe that the purpose of an entity's financial reporting is to communicate information to the market about the entity which the market does not already have. This new information might cause market assumptions to change, rather than merely confirming already existing market assumptions. For this reason, the market related measurement objective, which necessarily focuses on existing market assumptions, should not be considered more relevant than entity-specific measurement objectives in all circumstances.

  There is clear empirical evidence that an entity's market capitalization is influenced by market assessments of the quality of the entity's management. If management's skill is relevant to valuing the entity as a whole, it seems wrong to disregard management's insight into asset and liability values, as represented by the costs management decided to incur for them, in recording their initial accounting measurement." [Syngenta International AG – CL 23]

- "In our opinion, from a conceptual point of view, the most appropriate measurement concept for all assets, for both initial recognition and re-measurement, would be their value in use, provided it represents faithfully what it purports to represent and is free from material error and bias. Value in use would provide the most suitable information for users in making their decisions, because it would approximate the entity-specific measure of the present value of future cash flows. Value in use encompasses management's expectations as to the future cash flows the entity can generate through the use of the asset, realizing thereby its competitive advantages. On initial recognition, historical cost is the best available approximation of this value in use, because it has been evidenced by a transaction and therefore is both reliable and verifiable." [Institut der Wirtschaftsprufer – CL36]

- "… reporting entities may have private empirical data that can be proven as reliable by third parties. The reporting entity may use this data, which may not be available to other market participants, to better measure an asset or liability than measurements obtained from a market value measurement basis." [National Association of Insurance Commissioners – CL50]

- "We think it is an oversimplification to characterize every measure as either market-based or entity-specific, because there is a category of data that is neither market-based nor entity specific and we think that could lead to a category of measurement that is also neither market-based nor entity-specific. For example, mortality tables are neither market-based nor entity specific.

  The assumption seems to be that entity-specific data is more subjective than market-based data, but that is not necessarily the case. For example, a manufacturer may have data about the failure rates of its products. Such information is not subjective – it can be verified by independent parties – but is not information to which market participants generally have access." [European Financial Reporting Advisory Group – CL84]

- "The discussion paper does not … make clear why market-specific models should be given preference over an entity-specific measurement approach. The argument that the former delivers more relevant information fails to convince. Discussions currently underway about management commentary (*Discussion Paper: Management Commentary*) and segment reporting (*Exposure Draft: Segment Reporting*) highlight the benefits of a "management approach". These two recent publications by the IASB stress that the management perspective delivers information which can greatly assist investors in making their investment decisions." [Zentraler Kreditaushhchuss – CL28]

72. The discussion paper considers most of these arguments (see main paper paragraphs 112-121). It recognises that information on entity expectations – knowing the expectations, intentions and assumptions of management of an entity – can be of significant value to investors and others. The paper proposed that this information is best provided as explanatory or interpretive material, rather than being at the basis of the measurement objective for assets and liabilities on initial recognition. Clearly, many respondents do not accept this proposal and supporting analysis – and it must be recognized that, traditionally, many assets and liabilities have been accounted for on the basis of management's "best estimates" (for example, depreciation accounting) and, as noted in the comment of Zentraler Kreditaushhchuss above, some accounting standards are explicitly based on the assumption that it is important for users to have information that allows them to see the entity's financial position and results of operations "through the eyes of management". The responses on this issue underline the need to clarify the role of management expectations and intentions in financial reporting.

73. Finally, some respondents believe that the distinction between entity-specific and market expectations is not as absolute as the paper proposed – but that market value reflects entity expectations in some circumstances. Further, some believe that management's intentions should be distinguished from entity-specific measurement objectives. An example:

> "We agree that market versus entity-specific measurement objectives can give rise to totally different valuations, as the benefit to a particular entity of owning certain assets may be significantly different from the price that could be obtained for them in the market. However, it does not necessarily follow that entity-specific objectives are always irrelevant to the assessment of Market Value. If the objectives and performance of the entity are in line with

> those of most market participants, a valuation based on the entity's actual performance may still be relevant to the assessment of Market Value as it may be a guide to the performance of a typical market place participant.
>
> We agree that there is a clear distinction between market and entity-specific measurement objectives, and the former are far more relevant as a measurement basis on initial recognition. However, a clear distinction has to be drawn between entity-specific measurement objectives and management intentions. The latter are still relevant to the assessment of Market Value. For example, if management considers an asset to be surplus and intends to dispose of it, its Market Value could be quite different from its Market Value if management intended to retain it as part of the operating entity, where its Market Value would be assessed on the assumption that it was sold as part of the transfer of the whole operation as a going concern." [International Valuation Standards Committee – CL19]

What is an acceptable level of reliability?

74. *In proposing any measurement basis, the paper stipulates that the basis measure an asset or liability with an "acceptable level of reliability".*[18]

75. Though there is strong support for the use of an "acceptable reliability approach," many respondents criticize the paper for not defining the term in sufficient depth and detail. They are concerned with the potential misinterpretation and application of the term. The Federation of Swiss Industrial Holding Companies recommends that:

> "In order to operationalise the reliability test it is necessary to reach some sort of broad agreement on what is meant by 'sufficiently reliable' because at the moment there are significant differences of view. The paper does not address the issue. We accept that determining what is sufficiently reliable will always involve judgement, but the exercise of this judgement should not be arbitrary and this issue requires further analysis." [CL67]

Other respondents agree and recommend that additional guidance be provided, though no suggestions were received as to what that guidance would include.

Expanding the use of fair value

76. *The paper proposes that an asset or liability be measured at fair value if it can be estimated with an acceptable level of reliability on initial recognition and outlines alternatives, such as current cost or current consideration amount, historical cost, or models or techniques, to use when an acceptable level of reliability is not achievable. As there is not a clean division between initial and re-measurement,*

[18] See the main paper, paragraph 423 and 431.

the paper explains that any conclusions reached with respect to measurement on initial recognition are necessarily tentative and subject to reassessment when their potential implications for re-measurement are considered.[19]

77. Many respondents, including some of those who generally support the directions proposed in the paper, are concerned that the FASB and IASB are pushing towards an inappropriate expansion of fair value measurements. There is a widespread concern that this is happening without adequate study and debate. UK 100 Group express this concern in the following terms:

> "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, among other things, fair value measurement, and follow them with a conceptual framework that will be tailored to fit those standards. We hope we are wrong." [CL43]

78. A number of respondents seem to suspect that the paper's conclusion as to the relevance of fair value on initial recognition is a first step towards comprehensive fair value re-measurement of all assets and liabilities. This is not true. A measure used on initial recognition, whether it is fair value, historical cost, or some other measure, would not necessarily be its measurement going forward. The measure might be left at that amount, or amortised, or re-measured in subsequent periods depending on standards for the subsequent accounting for the particular asset or liability. Such an explicit statement should have been made in the paper.

79. Some respondents suggest that there should be no further expansion of the use of fair value pending further in depth consideration by the Boards of its relevance and reliability.

Need to consider costs of the proposals

80. *The paper evaluates possible measurement bases against the conceptual framework criteria, including cost benefit constraints.*[20]

81. Many respondents feel the paper should have weighted the costs against the benefits of using more fair value measures, including considering the costs to develop and maintain procedures and controls to ensure a high quality fair value

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[19] See the main paper, paragraph 423 and 432, and the condensed paper, paragraph 7.
[20] See the main paper, chapter 2, paragraph 52-53.

measurement can be determined. From this perspective, respondents state that the proposals are not operational.

82. To outline the significance of these concerns, F. Hoffmann La Roche and Federation of Swiss Industrial Holding Companies referred to their

> "first-hand experience of applying current-cost accounting in past years would expect that the real, on-going costs of doing such [fair value] valuations to be substantial for non-financial, non-traded assets and liabilities and express difficulty in identifying any tangible economic benefits from them. While we acknowledge that the paper does not advocate widespread use of current cost accounting, that experience is relevant because fair value measurement could in our view prove an equally difficult and costly process to implement for some assets and liabilities. Jurisdictions with an endorsement process could well have difficulty in accepting such appreciable extra costs as being in the public interest"[CL41 and CL67].

83. No respondents identify or refer to possible benefits users, entities or others may experience from these proposals, or costs they incur by not having such information.

NEXT STEPS

84. The paper, comment letters received and this report are available to the IASB and FASB board members and staff for further consideration in various projects, including the measurement phase of the Joint Conceptual Framework project.

85. The paper and respondents' views have provided significant insights into complexity of financial measurements. These issues warrant further thought, research and discussion.

86. Staff of the Canadian Accounting Standards Board strongly support the further development of these concepts and the inclusion of a robust section on measurement in the conceptual framework. We intend to further consider a number of the implications of the paper for accounting standard setting in light of the responses and to develop additional materials as input to those dealing with relevant projects.