Accounting Standards Board

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6 April 2006

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Dear Stig

IASB Discussion Paper "Measurement bases for Financial Accounting—Measurement on Initial Recognition"

We are in the process of considering our views on the above IASB Discussion Paper, and shall finalise our views, taking into account opinions expressed at a round table we are hosting in London on 24 April. We note Paul Ebling will be participating in this meeting and are sure his participation will be useful to both the ASB and EFRAG.

The EFRAG draft response is of a very high standard and expresses many views with which we strongly share. More specific points are set out in the Appendix, where the shaded boxes highlight where we would tend to disagree, or express a similar point in a different way.

We hope that EFRAG finds our suggestions and comments helpful in understanding our thought processes. If you would like to discuss any of these points please contact me, Andrew Lennard or Jennifer Guest.

Yours sincerely

Ian Mackintosh
Chairman, Accounting Standards Board
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APPENDIX

EFRAG's General Comments

1.1 In section 1 of EFRAG's response, we agree with the primary EFRAG criticism of the Canadian paper, that is, the danger of focusing on initial measurement, is that it draws conclusions from initial measurement that are in isolation from any subsequent measurement. The two are inextricably interrelated and need to be analysed together before drawing any conclusions. We agree that it is helpful to consider the implications of measurement bases for reported financial performance

1.2 Section 1 also highlights EFRAG's concern that a critical factor to measurement is the reporting of transactions and how gains and losses are reported. We agree with EFRAG that it is important for users of financial statements to be able to discern the difference between transactions reported and changes in value.

1.3 The second major criticism (section 2) is that EFRAG does not share the view of the discussion paper, that perfect[1] markets are the norm. The ASB concur with EFRAG on this view. Perfect markets are found in text book theory. They are the departing point of debate, but they are rarely evidenced in the real world of business; indeed this is what differentiates markets and prices; imperfect markets are where inefficiencies are profiteered from. The majority of markets are not liquid or always active, and transaction costs are often significant and central to a transaction, not peripheral or inconsequential and influence the behaviour of buyers and sellers in a transaction.

1.4 For the debate to move forward on measurement, an acknowledgement that markets are rarely perfect and do not always perform efficiently is needed. A further study of the imperfections of markets, prices and values is needed to determine the relevance and reliability of possible amounts for use on initial measurement.

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1 The Canadian paper refers to efficient markets, but in agreed economic terms the terminology is perfect markets. Indeed perfect markets (where the equilibrium market price is unaffected by individual transactions) are a subset of efficient markets.

1.5 Another main failing of the Canadian paper, as EFRAG correctly points out, is that it does not explain fully the objective of fair value measurement. What view should a companies' financial statements portray of its financial position and performance? The view should be relevant, reliable, but, at the same time, understandable for the user and comparable between entities.

1.6 The ASB agrees with EFRAG that the paper's assumption that the decision-usefulness of the financial statements is maximised if the entity's performance is measured against market value is a statement which needs to be substantiated by evidence to be credible.

1.7 We strongly agree with EFRAG's comments in section 3 that the objectives of financial statements should encompass stewardship and accountability. It is to be hoped that a general debate on accounting measurement, which EFRAG has called for and we are promoting in the UK, for example in our forthcoming round table, will clarify the importance of this point, which we believe may be significant.

1.8 In section 4, EFRAG concludes that in order to determine the correct measurement choice, one needs to consider the needs of the user first and work backwards to ascertain the optimum fit for the user. The IASB paper does not go into detail on this approach and we share EFRAG's view that greater depth and analysis is needed here.

1.9 On page 5, bullet point 1, we would expand the brackets on line 3 to read (ie historical cost).

2 Comments on specific questions

Q2.(a) EFRAG expresses concern about the definition of historical cost because of its interpretation in the event of an asset being constructed over time and hence a difficulty arises in using value as at the date of acquisition of the constructed asset (ie the date it becomes operational). The Draft EFRAG comment seems to suggest that it would be better to use the accumulated cost incurred in constructing the asset. We recognise that cost inefficiencies can and do occur, and we question whether they should be recognised in calculating historic cost.

More analysis around the date of acquisition would have been a useful addition to the paper and could have been suggested by EFRAG.

(b) Regarding EFRAG's comment on (b) we believe the comments are misplaced. A later section of the Canadian paper (starting at paragraph 164) addresses whether value in use should be based on an entity's own projected cash flows or on other, more objective values.

(c) We agree with EFRAG's comment.

(d) We agree that there is a need to define fair value more precisely. Additionally, the use of fair value in the paper is more appropriately described as fair price. Market value would be a more appropriately accurate term to use, given the analysis in the paper.

Q3. With regards to transaction costs, we follow the reasoning of the paper that transaction costs should be expensed, because they are costs which are not recoverable in the market place; however we share EFRAG's view that the question of recoverability of costs (or not) is central to pricing mechanisms and not necessarily about accounting measurement. We believe it is the total cost which is relevant to decision making and transaction costs are part of total cost, so it is difficult to argue they should be omitted as users need to know about decision making for the financial statements to be decision useful.

Q4. 'Market value measurement objective' seems to be a term derived from finance literature. Since in practice we do not believe that efficient markets are the norm, we share EFRAG's concerns.

In relation to part (c) we follow the reasoning used and agree that the paper needs to be more persuasive in its arguments to enable the reader to buy-into the conclusion that fair value is more relevant (being market based) than entity-specific. So far we are not persuaded that, in the absence of an efficient market, the market value measurement objective is appropriate.

Q5. We would disagree with the implication of the first sentence of EFRAG's draft response that paragraphs 57 and 58 provide a satisfactory discussion of 'entity specific' measures. We share the view, noted in EFRAG's draft response to question 16, that the paper is inconsistent in its usage of the term 'entity-specific'. Although it is defined as "A measurement of an asset or liability of an entity that is based on the expectations of management of the entity" (see Appendix A to the long version of the paper) it is often used to describe any measurement basis other than fair value—which seems especially worrying in the light of the suggestion that there can only be one market (fair) value for any asset.

Q6. We share EFRAG's view that relevance of either market or entity-specific measurement objectives is subject to the assumption of the paper that markets are invariably efficient, which is not a view we share. The logic of the reasoning of the paper is sound but the original assumptions are flawed.

Furthermore, we share the view that the paper assumes without explanation (other than the logic of sticking to the same course whilst on it) that a measure that is a very good proxy for market value is a more relevant measure for accounting purposes than a measure that is not a good proxy for market value.

Q7. Since we believe that, in the absence of an efficient market, fair value is subject to the position of the entrant or player in the market, we do not believe (in common with EFRAG) that it can be reasoned there is only one market (fair) value.

Q8. We agree with the logic of the argument that there should be no difference of treatment for assets or liabilities; however we share EFRAG's concerns about incorporating the reporting entity's own credit risk in the carrying amount of their liabilities and would question if this move would improve the quality of the information provided to users. Additional information, does not necessarily lead to better quality information.

Q9. Whilst we agree with the underlying thoughts expressed in EFRAG's draft answer, we note that many question whether management's intentions – or indeed expectations - should affect the reported financial position and performance. The point may perhaps be more persuasive if it relied on the unit of account issue being subject to the economic constraints to which the entity is subject and economic opportunities to which it has access.

Q10. We agree with the arguments put forward in the paper and by EFRAG, that further research is needed into multiple markets and their implications for measurement on initial recognition. However, we tend to agree with the paper's suggestion that entry values will often be appropriate on initial recognition.

Q11. Please refer to our Q3. for our views on transaction costs.

We commend EFRAG for suggesting that, if the reporting entity is indifferent as to what makes up the total cost, then the paper needs to explain persuasively why users are not indifferent, as there is an inconsistency of logic here.

Q12. We sympathize with EFRAG's view not necessarily to place a greater importance on relevance than on reliability; however, we note that the IASB ED 8 'Operating Segments', also places more importance on relevance over reliability or comparability.

Q13. We agree with the proposed sources and the supporting discussion; however we, like EFRAG, would like to see the paper address the meaning of 'sufficient reliability', because it would be helpful if it were more clearly defined.

Q14. We, like EFRAG, do not agree that fair value is the most relevant measure of assets and liabilities on initial recognition, when an efficient market does not exist. We believe that this part of the paper enters too much into the realms of theory and idealism and should focus more on what would work in practice and what the needs of users are. Thought also needs to focus on keeping costs of the preparer to a minimum, balanced with the perceived usefulness.

We concur with EFRAG's thoughts on the use of exit values and that they are not applicable to a business which is a going concern. We are also concerned that performance reporting becomes more complicated with the need to extricate useful information out of fair value gains and losses. We fully support the view that decisions on measurements cannot be taken in isolation from decisions about presentation and disclosures.

Q15. We agree with all of EFRAG's points addressed in this answer.

Q16. The paper's analyses and conclusions with respect to relevance and reliability of the different measures are logical but subject to the paper's original assumptions, so it is natural that analyses and conclusions are not necessarily objective. We share EFRAG's view that more analysis of the differences between the resulting measurement amounts would have been helpful here.

Q17. We fully share EFRAG's view in its comments addressing this question. We suggest that the paper has placed more importance on consistency with the fair value measurement objective rather than analyse whether this is in the best interests of the user. If being consistent does not produce the best answer then it does not make sense to be consistent. Some acknowledgement here that that the best answer may be a mix of measures might help to solving for the problem. This answer also ties up with our point about the lack of relevance of measurements derived from a hypothetical market.

Q18. We understand why EFRAG has chosen not to directly answer this question. Whilst the hierarchy is still undergoing change at the FASB it may be appropriate to delay comment until firm conclusions are reached. It would however be beneficial for EFRAG to state this in its response.

Q19. We believe that this subject matter is both complex and controversial and hence believe it would be beneficial if more research could be conducted, as suggested in the paper in order that some of the main controversial issues can be surpassed and for there to more solidity behind assumptions before conclusions are reached. Research needs to lead us to the best answers, which may not necessarily be the easiest ones to fit into a new standard.