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DISCUSSION PAPER: MEASUREMENT BASES FOR FINANCIAL ACCOUNTING – MEASUREMENT ON INITIAL RECOGNITION

Memorandum of comment submitted in May 2006 by the Institute of Chartered Accountants in England and Wales, in response to the discussion paper 'Measurement Bases for Financial Accounting – Measurement on Initial Recognition', published by the International Accounting Standards Board in November 2005

Contents **Paragraph**

INVESTOR IN PEOPLE

Chartered Accountants' Hall PO Box 433 Moorgate Place London EC2P 2BJ
Tel 020 7920 8100 **Fax** 020 7920 0547 DX 877 London/City **www.icaew.co.uk**

INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales ('the Institute') welcomes the opportunity to comment on the discussion paper *Measurement Bases for Financial Accounting – Measurement on Initial Recognition*, published by the International Accounting Standards Board (IASB). As discussed below, the paper provides an important discussion of some of the central questions in financial reporting measurement, and helpfully exposes some major conceptual questions. However, we are strongly opposed to its conclusions.

WHO WE ARE

2. The Institute of Chartered Accountants in England and Wales is the largest professional accountancy body in Europe, with more than 127,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.

3. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry (DTI) through the Financial Reporting Council. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy.

MAJOR ISSUES

Scope of the paper

4. The discussion paper's scope is limited to the measurement of assets and liabilities on initial recognition. At the same time, the paper is stated to be the first stage in a larger project to consider the measurement of assets and liabilities in general. Given the scope of the larger project of which it is intended to form a part, we do not think the scope of this particular paper makes good sense.

5. The paper inevitably discusses considerations relating to measurement that are applicable to measurement issues wherever they arise in financial reporting. Some general conclusions on the subject are then applied to the question of measurement on initial recognition, but not to other asset and liability measurement questions. The measurement of income and costs is also excluded from the paper's scope, even though its recommendations necessarily have important implications for this subject, and even though in at least one respect the paper's proposals are supported by reference to their income effects. This approach creates at least three difficulties.

6. First, for most assets and liabilities, measurement on initial recognition is not widely seen at present as a question that gives rise to practical problems in financial reporting. As the paper proposes a radically new and potentially expensive approach to the issue, the lack of an obvious problem that needs to be

dealt with here considerably weakens the case for change. As the paper's proposals apply only to initial recognition, it might be expected that there would be an argument as to why the radical change proposed is peculiarly appropriate in this situation. But this case is not made.

7. Second, the logic of the paper's approach, though its proposals are not explicitly taken beyond initial recognition, is that there should be a much more extensive change in measurement in business reporting. It is possible (though this is not a position that we would necessarily support) that there is a case for such a change. But if it is to be advanced, it clearly needs to be articulated in a way that addresses asset, liability, income and cost measurements comprehensively. We consider the income measurement implications of the paper's proposals to be especially important, and it is therefore particularly unfortunate that they are not (except in one respect) addressed in the paper. Taking one aspect of measurement in isolation, especially one where there is not generally seen to be a problem, unavoidably weakens the case for change.

8. Third, there is a lack of clarity as to how the different parts of the project will fit together. This first paper deals with initial recognition, and it is stated (in paragraph M16)[1] that "subsequent stages [of the project] will analyze alternative bases for re-measurement of existing assets and liabilities when accounting standards require re-measurement, and will include consideration of measurement upon the recognition of asset impairment." It is not clear how, for example, depreciation as a measurement process fits into this programme. The paper on initial measurement is concerned to establish a measurement at the date of acquisition of an asset, rather than at its first balance sheet date; the question of depreciation does not therefore arise. While one might regard depreciation as a form of re-measurement, or as a way of recognising impairment, this is not how it is usually described, and it is therefore unclear where it will fit into the measurement project.

A radical departure

9. The paper's key proposal is 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. As a last resort, items would be measured at historical cost. This would be a dramatic change from current practice. At present, assets and liabilities are usually recognised initially at their historical cost (with some exceptions, such as financial instruments). We believe that this is a system that works well and does not need to be changed. While some people might take a relaxed view that historical cost and fair value will generally be identical, the paper points out that one cannot assume this:

> "*Every day people get bargains or pay more than fair value for goods and services. Individual transaction prices may exceed or be less than fair value because of ignorance, inadequate research, convenience, or disadvantageous bargaining positions, among other reasons*" (paragraph C108).

[1] References to the condensed version of the discussion paper are prefixed with a C. References to the main paper are prefixed with an M.

10. Adjustments to fair value might also be required where there is an interval between ordering an item and its delivery or where prices are agreed some time in advance (paragraph C179). Other situations where adjustments would be required, though not discussed in the paper, can also be imagined. For example, where there is a prepayment for services – rents, for example – the value of the asset would presumably have to be adjusted to show the current fair value of the related service.

11. Adjustments to fair value could therefore be frequent and extensive. Indeed, they would be even more extensive than may be immediately apparent. Some readers of the discussion paper will probably assume that adjustments to values at initial recognition will only be required for those assets and liabilities that appear in the accounts at a date when a balance sheet has to be prepared. It is clear from the logic of the paper that this is not the case. The paper argues that one of the benefits of its proposed approach is that it "will … distinguish the net income effects of activities relating to the acquisition or creation of … asset[s] from the net income effects of subsequent activities" (paragraph C124). This implies that fair value adjustments on initial recognition would be required even for assets (and liabilities) that never appear in a balance sheet (e.g., trading stock bought and sold between balance sheet dates). Otherwise it would be impossible to distinguish between the net income effects of the acquisition of these assets, and the net income effects of other activities.

12. Making such extensive adjustments to the initial values of assets and liabilities (including those that never appear in the balance sheet) will be time-consuming and expensive. It will also require internal controls to be set up to ensure that the new financial reporting requirements are being complied with. Businesses will need procedures to ensure that they identify when they have secured a bargain, or for reasons of convenience made a purchase above fair value, or where prices have changed between the order and delivery dates, and so on, and to make the necessary adjustments to the accounts. Businesses that cannot ensure that they have identified all disparities between purchase prices and fair values may be judged to have inadequate internal controls for financial reporting purposes. Installing such controls could be a significant addition to costs. This may well be of particular concern to businesses that are required to comply with the Sarbanes-Oxley Act.

13. Fair values can be measured with complete reliability only where there are *markets* in the special sense defined in the paper (paragraph C55): "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." There are relatively few assets and liabilities for which such markets exist. Although the paper proposes that fair values should only be used where they can be measured reliably, existing standards already require use of fair values in circumstances where this condition is not met. It is therefore possible that, in practice, if a preference for fair value on initial measurement were established, it would be used even in circumstances where it cannot be measured reliably.

14. The paper does point to the problems that “Existing measurement standards and practices are inconsistent, and a number of significant measurement issues remain unsettled or have been dealt with unsatisfactorily” and that “The lack of an agreed, coherent measurement theory has impeded the advancement of accounting standards” (paragraph M8). These points are certainly worth considering, but they do not in our view indicate a serious practical problem on initial measurement. The introduction of the paper’s proposals in isolation would create fresh anomalies.

The broader context

15. The paper’s proposals are developed purely for assets and liabilities on their initial recognition. There seems to be no good case for changing these measurements, but not others. Logically, a comprehensive programme of measurement change might be expected to cover asset and liability measurement:

- on initial recognition;
- in balance sheets; and
- on derecognition

as well as the measurement of income and costs.

16. A proposal restricted to just one of these measurement issues needs to indicate either how it fits into a larger scheme of reform or why it is appropriate to deal with this issue in isolation. The discussion paper does neither of these things. The arguments in the paper in fact seem to be applicable to financial reporting measurements generally, but – because of its restricted scope – it does not discuss whether its proposals for measurement on initial recognition would be equally (or even more) valid for other measurements.

17. In addition to the general problem of lack of discussion of income measurement, the absence of guidance on how fair value adjustments on initial recognition should be dealt with in the income statement (apart from the passing reference at paragraph C124) is an important gap - especially as many of these adjustments will impact the income statement, but not the measurement of assets and liabilities in the balance sheet.

Theoretical arguments on fair value

18. The theoretical arguments for the proposed approach in the paper seem to us to be unconvincing. For the arguments as set out in the discussion paper to apply, there need to be fair values available from *markets* as they are defined in the paper. Such markets can only be expected to exist in certain special cases, such as for securities, currencies and commodities. It seems illogical to base arguments for measurement generally on considerations that apply to only a small range of assets and liabilities.

19. Although the paper adopts what it calls a top-down, deductive approach (paragraph M26) in arriving at fair value as the preferred basis of measurement,

the deductions that emerge from a process of this sort are heavily dependent on a few key assumptions, which are themselves open to question. For example, it would be reasonable to require, though the paper does not require it, that any preferred valuation basis should be one for which information is readily available for assets and liabilities generally. Fair value fails this test because of the limited range of assets and liabilities for which there are ‘markets’ (as defined by the paper). Or one might start from the premise that measures of income are more useful than balance sheets in helping to forecast future cash flows, and therefore treat the measurement of assets and liabilities as – in this respect - secondary to the measurement of income.

20. Where there is not a market in the sense defined by the paper - the usual case for most assets and liabilities – it is assumed that it will often be possible to arrive at fair values by adjusting market values for differences in the value-affecting attributes of items. While this may often be feasible, we believe that it is an approach that needs to be handled very carefully. Part of the point of markets is that it is impossible to predict what prices they will arrive at. Acting as though it is possible to arrive at market prices in the absence of markets is theoretically dubious - and will often give misleading results.

21. In practice, there is a spectrum of degrees of activity for markets, and different assets can be placed at different points on the spectrum. At one extreme, there are highly active markets for assets such as listed securities and certain commodities. For other assets, trades are sufficiently frequent that it is often possible to estimate a market price with what most people would regard as reasonable reliability within a greater or lesser range of error. Further down the spectrum, there are many assets that are not usually traded in the form and condition in which they appear in a company’s balance sheet. These would often include a business’s fixed assets and its stocks (excluding those ready for resale) and work in progress. For these assets, fair values would not typically be available, and it seems to us to be questionable to elevate to preferred status a basis of measurement that cannot be applied to the generality of business assets.

22. Where reliable fair values can be arrived at, the paper argues that they should be used because they provide the best indication of the present risk-adjusted value of the future cash flows likely to arise from an asset. We doubt whether for many business assets this is in fact the case. The paper states (paragraph C54) that “Competitive market forces in an open and active market serve to resolve the diverse expectations and risk preferences of individual market participants in respect of an asset or liability to a single price that can be expected to earn the current rate of return available in the marketplace for commensurate risk on the measurement date.” This is true of assets traded in markets as defined in the paper, such as those for listed securities. It becomes progressively less true as, moving down the spectrum, markets become less active.

23. Where a business holds securities, the cash flows to that business from holding them will be precisely the same as those to any other business holding the same securities, and if it is wished to use a balance sheet date valuation to predict the risk-adjusted cash flows arising from those securities, their market value would (as a rule) be the best valuation to use. It does not follow that adding up the

estimated market values at their date of acquisition of all the recognised separable assets and liabilities that are not securities provides a good basis for predicting a business's future cash flows, and we very much doubt that it would do so. Disregarding securities, a business's assets (recognised and unrecognised) give rise to cash flows jointly (as the paper points out in paragraph C168). These jointly-produced cash flows are extremely unlikely to coincide with the cash flows that the assets would generate separately, and there seems to be no reason to believe that their market values should be regarded as a useful basis for outsiders to forecast what cash flows they will generate within the business. (From this point of view, their value in use would be more relevant.)

24. Investors draw information from a wide range of sources in making forecasts of the amounts, timing and uncertainty of future cash flows. So far as they are relying on information from the accounts for this purpose, the balance sheet – on whatever basis it is prepared - is probably a less useful source of information than either the cash flow statement or the income statement. It is therefore important to consider what the income-statement effects would be of the proposed change in the basis of measurement on initial recognition and to consider whether these effects would help users assess future cash flows. As (with the exception noted earlier) no consideration is given to these issues in the paper, it is impossible to say whether in this respect the proposed change would have any beneficial effects in terms of the information that it would provide for users. This seriously weakens the case for making it.

25. We also consider that for investors an important function of accounting is reporting on past performance. The financial reporting information needed to do this may or may not be of use in helping to forecast future cash flows. But it allows investors to judge managers' performance and helps them to form judgements on the reliability of other sources of information that may be more directly relevant to forecasting future cash flows.

26. As noted above, there is a passing reference at paragraph C124, as a benefit of the paper's approach, that it "will … distinguish the net income effects of activities relating to the acquisition or creation of … asset[s] from the net income effects of subsequent activities". It would be useful to know what the evidence is that this would help users in forecasting future cash flows.

27. Even if it were true that fair value provides the best indication of future cash flows, this seems to be an argument for the use of fair value measured at the balance sheet date rather than at the date of acquisition.

28. We do not regard the use of fair values in measuring the assets and liabilities in a business acquisition as a precedent for the wider use of fair value on initial recognition. In a business acquisition there is a need to establish an initial measurement for the assets and liabilities acquired in the absence of a historical cost figure, as payment is made for the business as a whole, not a series of separate payments for its separable assets. The use of fair value in these circumstances can therefore be regarded as a proxy for historical cost in a situation where there are no historical cost figures available for separable assets and liabilities.

29. Similarly, the case for fair valuing financial instruments – for which, in many cases, there is no historical cost – does not seem to us to be applicable to assets and liabilities generally. The use of fair value on initial recognition for financial instruments needs to be seen in the context of the more general requirements for the use of fair value for such assets and liabilities. There may be other cases in particular industries (which are outside the scope of the discussion paper), where a current-value approach would be appropriate.

Theoretical arguments on current cost

30. Where fair value cannot be measured reliably, the paper proposes that assets and liabilities should be recognised initially at their current cost, where this can be measured reliably.

31. The paper argues that current cost is more relevant than historical cost because it shows "the most economic amount that rationally could have been paid or received on initial recognition" (paragraph C148). This argument is debatable on two grounds. In the first place, we do not see that where there is a difference between historical cost and current cost, it necessarily follows that the current cost is more "rational" than the historical cost. In our view, there should be a presumption, in the absence of evidence to the contrary in specific cases, that businesses behave rationally in conducting market transactions and that, therefore, the prices at which they enter into transactions are also rational. Secondly, even if it were true that current cost is in some sense more rational than historical cost, it is not explained how recording assets and liabilities at their current cost at initial recognition will assist any of the purposes of financial reporting – including forecasting future cash flows.

32. There has been significant experience of current cost accounting, in the UK and other countries, in the 1970s and 1980s, and the results of those experiments were not found so positive and compelling in terms of their benefits for users that it was thought worthwhile to continue them. In particular, current cost measurements were often seen as either unreliable, irrelevant, or both.

33. As with fair value, if there is a case for the more general use of current cost (and we remain to be convinced that there is), then it would seem to be stronger for measurement at the balance sheet date than at the date of acquisition.

The future of the project

34. As noted above, the paper is stated to be the first stage in a larger project looking at bases of measurement in financial accounting. While this is an important subject, and one that certainly deserves consideration, we believe that it is best pursued by the IASB as part of its project with the US Financial Accounting Standards Board (FASB) to develop a common conceptual framework. The separate project on measurement was commissioned before the conceptual framework project was decided on, and now that the latter is in progress the former seems to be rather an anomaly.

35. Indeed, although it is stated that the paper "represents the first step of [IASB's] due process for the measurement aspects within the broader conceptual framework project" (M, Introduction), the paper does not read as though it forms an integrated part of that project, and we think that as long as the measurement and conceptual framework projects are running in parallel, the relationship between them will be an awkward one.

36. For these reasons, we recommend that the separate project on measurement should not be pursued beyond the discussion paper that has already appeared, and that work on this subject should be fully integrated into the conceptual framework project. As measurement questions are closely connected to revenue recognition questions, we also recommend that further work on measurement should be integrated with the IASB's project with the FASB on revenue recognition.

Conclusions

37. As noted above, the paper provides an important discussion of some of the central questions in financial reporting measurement, and helpfully exposes some major conceptual questions. However, we are strongly opposed to its conclusions, which we consider to be mistaken on theoretical grounds and potentially costly in practice, for no corresponding benefit to the users of financial reporting information. This would be especially the case for SMEs. The ideal of greater consistency in measurement practices is certainly worth considering, and our comments should not be taken as intended to dismiss it. But for measurement on initial recognition there is in fact a fair degree of consistency already, with historical cost the usual basis of measurement, and fair value being used as a proxy for it when historical cost figures are unavailable or in special cases such as financial instruments. This situation seems to us to be broadly satisfactory.

38. Issues unique to particular industries are outside the paper's scope, and our comments are not intended to preclude a current-value approach for particular industries (such as insurance) where this may be appropriate. But whether such an approach is appropriate for particular industries should, in our view, be considered looking at each industry's financial reporting as a whole, and not isolating the question of measurement on initial recognition.

39. Our key points on the paper have been made in these general comments, and to avoid repetition we have not set them out again at equal length in the responses to specific questions below.

RESPONSES TO SPECIFIC QUESTIONS

Q1. Do you agree that the list of identified possible measurement bases (see paragraphs 33-51 of the condensed version and paragraphs 69-74 of the main discussion paper) sets out the bases that should be considered? If not, please indicate and explain any changes that you would make.

40. We agree with the list of identified possible measurement bases.

Q2. Do you agree with the working terms and definitions, and supporting interpretations, of each of the identified measurement bases (see paragraphs 33-51 of the condensed version and paragraphs 77-96 of the main discussion paper)? If not, please explain what changes you would make. In particular, do you have any comment on the term "fair value" and its definition (in light of the discussion in paragraphs 46-48 of the condensed version and paragraphs 88-93 of the main discussion paper)?

41. We disagree with the paper's definition of *historical cost*:

> "*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*."

It might be deduced from this definition that the cash paid for an asset is only of interest as a form of fair value. In our view, the emphasis should be the other way round. As a rule, the historical cost of an asset will be the cash amount paid for it. In some cases, where assets are not acquired for cash, it will be necessary to ascertain the fair value of the consideration given. But fair value should be seen as a recourse in special situations, not as the general rule. We prefer the IASB's definition and do not agree with the paper's arguments for departing from it. The IASB's definition is:

> "*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 … at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business*."

Q3. 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.
(See paragraph 52 of the condensed version and paragraph 97 of the main discussion paper.) This proposal and its conceptual implications are the subject of chapters 4 and 5. 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.

42. Although the paper states 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," it is not explained how these sources of differences produce the actual differences between fair value, historical cost, current cost, net realisable value, value in use and deprival value. While the arguments in favour of this proposition have not been put (at any rate in the discussion paper), there seem to be some obvious arguments against it.

43. Although most real world markets are not markets as defined in the paper, with this qualification, all measurement bases have a market value measurement objective. That is, they "look to market prices of assets and liabilities", but usually to less-active-market prices rather than to those of markets, as defined.

44. In practice, the sources of difference between measurement bases lie in the nature of the market transactions that are referred to. While measurement bases often involve complex mixtures of transactions in arriving at particular measurements, the typical transactions for each basis (for assets) are as set out below. In this analysis, transactions at the balance sheet date are treated as past transactions, which is what they are by the time the accounts are prepared. However, there is a difference between past transactions at the balance sheet date and those at an earlier date:

- Historical cost: actual past entry transactions.
- Fair value: hypothetical past transactions at the balance sheet date.
- Current cost and deprival value: hypothetical past entry transactions at the balance sheet date.
- Net realisable value: hypothetical past exit transactions, against which hypothetical past entry transactions are netted – all transactions at the balance sheet date.
- Value in use: hypothetical future exit transactions, against which hypothetical future entry transactions are netted.

45. On this analysis, the fundamental sources of differences between the identified bases for measuring assets and liabilities on initial recognition are whether they are based on:

- actual or hypothetical transactions;
- past transactions (either before or at the balance sheet date) or future transactions;
- entry or exit transactions, or the net effects of both.

As noted, in practice, measurement may well involve reference to several different types of transaction.

46. Although the intention for all these measurement bases is to use market prices, the extent to which this is possible and the manner in which it is achieved vary from basis to basis. For example, to the extent that it is based on actual transactions, a historical cost measurement may be based totally on market prices. A fair value measurement based on an offered price taken from an active and liquid market will also be based on an actual market price, but as the asset being measured was, by definition, not sold at the measurement date, there was no actual market transaction to establish the price, only a hypothetical one. Where fair values are calculated using, e.g., models of future cash flows, then the measurements are based on hypothetical future transactions.

47. We do not at this stage offer any proposals on how the fundamental sources of differences between different measurement bases that we have identified should be examined and tested. It is not clear from the discussion paper in what way (a)

the market versus entity-specific measurement objectives, and (b) differences in defining the value-affecting properties of assets and liabilities, have been examined and tested, and we are not sure what kinds of examination and test are considered appropriate in this context.

Q4. The paper analyzes the market value measurement objective and the essential properties of market value.

(a) Do you believe that the paper has reasonably defined the market value objective and the essential properties of market value for financial statement measurement purposes (see paragraphs 54-56 and 105-112 of the condensed version and paragraphs 99-110 and 236-241 of the main discussion paper)? 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" (see paragraphs 55-56 of the condensed version and paragraphs 107-110 of the main discussion paper)? 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 (see paragraph 102 of the condensed version and paragraphs 111, 228 and 229 of the main discussion paper)?

48. (a) We have no objection to the definition of the market value objective, but in our view the distinction between market versus entity-specific measurement objectives is overemphasised in the paper, especially in the context of initial recognition. In market economies, businesses generally acquire assets and liabilities in the market at market prices. These market prices may well differ from the fair values that would be generated using the discussion paper's market value objective, which would produce values that it is estimated would have prevailed if the markets in which the assets were acquired had been highly active ones. But in our view the prices businesses pay and receive in actual markets are generally good enough for accounting purposes.

49. (b) We have no objection to the paper's definition of "market" as long as everybody realises that most markets do not fit it. The definition applies only to a minority of highly active markets.

50. (c) For the reasons already explained, we do not agree with the fair value measurement objective as an objective.

Q5. Do you agree with the definition and discussion of entity-specific measurement objectives (see paragraph 57 of the condensed version and paragraphs 112-116 of the main discussion paper) and their relationship to management intentions (see paragraph 58 of the condensed version and paragraphs 117-121 of the main discussion paper)? If not, please explain why you disagree.

51. We do not agree that "entity-specific measurement objectives", in accordance with which managers' judgements are preferred to those of the market, are generally an issue in relation to initial recognition. The historical cost of an asset or liability is certainly an entity-specific cost (i.e., it is what a specific entity paid or received), but – with some exceptions, notably self-constructed assets - management expectations and intentions are not usually relevant to calculating the cost of an

asset or liability at the time it is acquired. Entity-specific estimates are more likely to intrude into measurement on initial recognition if a fair value basis is adopted, because of the lack of markets (in the sense used in the paper) for most assets and liabilities, and the consequential necessity in practice of substituting management judgements for market prices to a greater or lesser degree.

Q6. Do you agree with the comparison of market and entity-specific measurement objectives (see paragraph 59 of the condensed version and paragraph 122 of the main discussion paper) 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 (see paragraphs 60-61 of the condensed version and paragraphs 123-129 of the main discussion paper)? If not, please explain your views.

52. We do not consider that the case for the market value objective is argued convincingly. To recapitulate briefly the points made earlier:

- There is nothing obviously wrong with existing practice.
- Market values in the special sense defined by the paper are not available for most assets and liabilities, and it therefore seems questionable to make them the preferred form of measurement.
- For most businesses, there is no reason to think that the sum of the market values of a business's separable assets and liabilities provides a useful basis for forecasting its future cash flows.
- Even if it did, this would be a matter for balance sheet measurement, not for measurement on initial recognition.
- The income effects of the proposal are not worked out, and no case is made for them.

Q7. (a) It is reasoned that there can be only one market (fair) value for an asset or liability on a measurement date (see paragraph 62 of the condensed version and paragraphs 131-138 of the main discussion paper). Do you agree with this conclusion? If not, please explain why you disagree.
(b) It is proposed that differences between apparent market values for seemingly identical assets or liabilities on initial recognition may be attributable to:
(i) differences between the value-affecting properties of assets or liabilities traded in different markets, or
(ii) entity-specific charges or credits.
(See paragraph 63 of the condensed version and paragraphs 131-138 of the main discussion paper.) 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 (see paragraphs 74-82 of the condensed version and paragraphs 95-109 of the main discussion paper.)
Do you agree with these proposals, within the caveats and discussion presented? If not, please explain why you disagree.

53. We agree that, given the discussion paper's definition of a market, there can be only one fair value for an asset or liability on a measurement date. However, most markets do not meet the paper's definition.

54. We agree that, given the discussion paper's definition of a market, differences in market values imply differences in market-affecting properties. We do not see how entity-specific charges or credits are relevant in this context.

55. Given the paper's definition of a market, it is probably misleading to refer to the existence of multiple markets (and therefore multiple market prices) for the same asset. For example, as the paper itself explains (paragraph C77), the value-affecting properties of nails sold wholesale are not identical to the value-affecting properties of nails sold retail. Therefore the assets are different assets, traded in different markets. The same point can be made about differences in value arising from the unit of account. Where the value of an item is affected by the unit of account in which it is bought or sold, the unit of account must be a value-affecting property of that item. Markets for large blocks are effectively different markets from those for individual items and, unless large block trades are frequent, unlikely to meet the paper's definition of a market.

56. As a matter of daily observation, different businesses pay different prices for what appear to be in substance the same asset. As already noted, this is partly because there may be differences in the value-affecting properties of items that appear to be the same. But it is also because most markets in the real world are not *markets* in the sense defined by the discussion paper. Purchases of identical assets in real world markets are not necessarily at the same price.

57. For example, depending on their purchasing power, different buyers may pay different prices for what appear to be identical assets. There are various ways in which this could be interpreted:

    - One way of looking at the transaction is that the purchaser who pays a lower price has got a bargain, and that the asset acquired (if the approach proposed in the discussion paper is adopted) should immediately be written up to fair value.
    - Another way of looking at it is that the purchaser with greater buying power is buying in a different unit of account from smaller purchasers, and that this difference in value-affecting properties explains the difference in price.
    - A third line of analysis would be to conclude that the different buyers are in effect operating in different markets.

    These various ways of looking at differences in prices are not mutually exclusive.

58. Incidentally, the paper's observation (paragraph C108) that "Every day people get bargains or pay more than fair value for goods and services" is only applicable to transactions in markets that do not meet the paper's definition of a market. Transactions in markets as defined by the paper are always at fair value.

Q8. 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 (see paragraph 65 of the condensed version and paragraphs 142-147 of the main discussion paper)? If you do not agree, please explain the basis for your disagreement.

59. We agree with the paper's conclusion in those cases where the fair value is taken from a market as defined in the paper and if the paper's definition of fair value is assumed.

Q9. 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 (see paragraphs 67-70 of the condensed version and paragraphs 149-154 of the main discussion paper).
(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 (see paragraphs 71-73 of the condensed version and paragraphs 157-161 of the main discussion paper).

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

60. In our view the appropriate unit of account for a portfolio of assets depends on the basis of measurement. If the basis of measurement is historical cost, the appropriate unit is that in which it was acquired. If the basis of measurement is fair value or net realisable value, it is that in which it would realise the highest value. If the basis of measurement is current cost or replacement cost, it is that in which it could be most economically replaced. If the basis of measurement is present value, it is not clear that the issue arises, but if it does, the unit of account should be that in which the highest present value would be realised.

61. In our view, the appropriate level of aggregation for non-contractual assets is that adopted in current GAAP, and if our understanding is correct that is what the paper suggests.

Q10. 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 (see paragraphs 75-82 of the condensed version and paragraphs 162-182 of the main discussion paper). 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 and research you would think should be carried out.

62. This question does not arise if historical cost is the basis of measurement. Where fair value is the basis of measurement, the appropriate market would be that in which the asset could be realised at the highest value or the liability settled or transferred at the lowest value, taking transaction costs into account in each case (i.e., taking them into account in deciding which market to use, not in making the measurement to use in the accounts).

Q11. The paper concludes that transaction costs, as defined, are not part of the fair value of an asset or liability on initial recognition (see paragraphs 86-87 of the

condensed version and paragraphs 193-200 of the main discussion paper). 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?

63. We do not see that it is necessary to have a definition of transaction costs for the purposes of fair value. The fair value should be that of the asset or liability as it exists at the valuation date. Identification of the transactions that brought the item to its location and condition at that date, or of those that might subsequently affect it, should not be relevant.

Q12. 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 (see paragraph 89 of the condensed version and paragraph 202 of the main discussion paper)? If not, please explain why you disagree, and indicate how you would settle trade-offs between the relevance and reliability of alternative measurement bases.

64. For the reasons already explained, we believe that, in general, items should be recognised initially at their historical cost. We do not agree that relevance as it is analysed in the paper (which assumes that asset and liability measurement is about producing balance sheets that provide implicit forecasts of future cash flows and that market values of separable assets provide a useful basis for doing this) provides a valid basis for choosing one measurement basis rather than another.

Q13. Do you agree with the two proposed sources of limitations on measurement reliability – estimation uncertainty and economic indeterminacy – and supporting discussion (see paragraphs 90-100 of the condensed version and paragraphs 204-216 of the main discussion paper)? If not, please explain your view.

65. We agree with the paper's analysis on this point.

Q14. 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 (see analyses of fair value and alternative bases in chapter 7, and discussion of measurement date on initial recognition in paragraphs 179-180 of the condensed version and paragraphs 410-415 of the main discussion paper)? If not, please explain why.

66. We do not agree that fair value is the most relevant measure of assets and liabilities on initial recognition. In our view, historical cost is the most relevant measure on initial recognition, though there are circumstances (e.g., where there is no separable consideration) in which fair value can provide a pragmatically acceptable proxy for historical cost.

Q15. Do you agree that fair value is not capable of reliable estimation in some common situations on initial recognition (see paragraph 104 of the condensed version and paragraphs 232-277 of the main discussion paper)? 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 (see paragraphs 106-114 of the condensed version and paragraphs 243-252 of the main discussion paper), 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 (see paragraphs 115-118 of the condensed version and paragraphs 263-268 of the main discussion paper)?

Please provide explanations for your views on these questions if they differ significantly from the conclusions and supporting arguments presented in the paper.

67. We agree with the paper's analysis on these points.

Q16. Do you agree with the paper's analyses and conclusions with respect to the comparative relevance and reliability of:

> ***(a) historical cost (see paragraphs 120-137 of the condensed version and paragraphs 281-319 of the main discussion paper);***
> ***(b) current cost – reproduction cost and replacement cost (see paragraphs 138-154 of the condensed version and paragraphs 320-361 of the main discussion paper);***
> ***(c) net realizable value (see paragraphs 155-161 of the condensed version and paragraphs 362-375 of the main discussion paper);***
> ***(d) value in use (see paragraphs 162-169 of the condensed version and paragraphs 376-392 of the main discussion paper); and***
> ***(e) deprival value (see paragraphs 170-178 of the condensed version and paragraphs 393-409 of the main discussion paper)?***

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.

68. For the reasons given earlier, we do not agree that either the relevance of fair value or current cost measurements on initial recognition or the irrelevance of historical cost measurements has been demonstrated by the paper.

Q17. 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 (see paragraph 186 of the condensed version and paragraph 417 of the main discussion paper)? If not, please explain why.

69. We do not agree with the fair value measurement objective, and do not therefore have any comments on this point.

Q18. Do you agree with the proposed hierarchy for the measurement of assets and liabilities on initial recognition (see chapter 8)? If not, please explain your reasons for disagreeing and what alternatives you might propose.

70. For the reasons explained earlier, we do not agree with the proposed hierarchy. We propose that initial recognition of assets and liabilities should be left on its present basis.

Q19. Do you have comments on any other issues or proposals, including the proposals for further research (see paragraph 189 of the condensed version and paragraph 441 of the main discussion paper)? If so, please provide them.

71. We do not believe that the question of measurement on initial recognition, in isolation, merits further research.

Email: brian.singleton-green@icaew.co.uk

(ICAEW Rep 28/06 Discussion Paper: Measurement Bases for Financial Accounting – Measurement on Initial Recognition)