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AUSTRIAN FINANCIAL REPORTING AND AUDITING COMMITTEE

Comment Letter

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

AUSTRIAN FINANCIAL REPORTING AND AUDITING COMMITTEE

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The AFRAC International Financial Reporting Standards Working Group prepares comment letters on recent IASB publications for final approval by AFRAC. Principal authors of this comment letter were Otto Altenburger, Roland Nessmann, and Alfred Wagenhofer. More information about the Working Group and AFRAC is available under www.afrac.at.

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Outline

1. General comments

The Austrian Financial Reporting and Auditing Committee (AFRAC) welcomes the opportunity to comment on the discussion paper *Measurement Bases for Financial Accounting – Measurement on Initial Recognition* of November 2005, prepared by staff of the Canadian Accounting Standards Board.

The discussion paper begins with the observation that current measurement standards and practices are inconsistent, and investigates measurement bases for assets and liabilities on a conceptual level. Generally, we find it very useful to consider such important issues on this level. Inconsistencies tend to reduce the usefulness of accounting information and may even lead to the artificial structuring of transactions in order to achieve particular accounting outcomes.

The paper evaluates all conceptually important measurement bases based on the criteria contained in the IASB Framework and argues that fair value is the measurement base that fits these criteria best. Hence, the paper can be seen as another step in the IASB's (and the FASB's) move in the direction of increased fair value measurement.

The fair value measurement approach suggests there will be many circumstances in which fair value at initial recognition of an asset or liability differs from its historical cost. However, we find it a weakness that the paper does not specify how such differences are to be recognised. Implicitly, it seems to be proposing the recognition of these differences as revenue or expense in the period of the initial recognition. In the discussion of portfolios of assets, for example, it discusses a potential intangible asset that may arise in a transaction. This would probably be consistent with the application of the paper to business combinations, where such a difference would be goodwill.

In line with its fair value approach, the paper dismisses traditional historical cost measurement. It argues (paragraph 124, condensed version) that it is less informative than fair value because the latter can distinguish between transaction gains/losses and gains/losses from operations, or using the asset/liability. This argument implies that fair value is the benchmark for such a distinction. We would agree with this approach if fair value is indeed the price on an active market; in that case, markets define opportunity costs for every managerial decision. However, markets for most assets and liabilities are far from perfect . Indeed, the very existence of companies is based on market imperfections. Thus, we doubt that fair value (if not based on an active and liquid market) is a good benchmark. As we explain in detail in our answers to the specific questions, we believe that historical cost is generally a more meaningful measurement basis, except where there is persuasive evidence that it is not. The paper seems to accept this argument too, although perhaps only for pragmatic reasons.

The paper states (paragraph 126, condensed version): “Historical cost may be useful in predicting future reported net income. However, this does not in itself have any necessary implications for future cash flows. Fair value, on the other hand, does embody the market’s expectations for those future cash flows.” We do not agree with this statement. First, predicting future net income is a major concern of users of financial statements, as is evidenced by the importance of earnings per share in financial analysis and forecasting. Second, net income and cash flows are linked in the long run. And third, if there were real interest in predicting future cash flows, value in use, by definition, would be the most relevant measure because users are interested in the entity’s cash-generating process and not a process that is based on what an average market participant might earn by using the asset or liability. We believe these points indicate a fundamental weakness in the paper, and not just a semantic problem.

The paper restricts its analysis to measurement on initial recognition, as a first step in a more general analysis of accounting measurement. First, we stress that initial measurement can hardly be discussed without simultaneously discussing recognition itself (definition of assets and liabilities). And second, we believe that it is difficult to evaluate the benefits and costs of different measurement bases for only this one use, as there are clearly consequences for subsequent measurement. For example, the paper discusses the case in which an entity purchases an asset at a fixed price which differs from the fair value of the asset at the time of delivery. The paper argues (paragraphs 179-180 of the condensed version) that the fair value at the time of first recognition, which is the time of delivery, is more relevant than the price agreed upon. The difference between the price and the fair value are the result of a contracting rather than an operating effect. This reasoning can easily be extended to subsequent measurement. Indeed, the purchase agreement itself can be considered as a right to delivery (which is the subject of discussion in current revenue recognition projects). Thus, the analysis in the paper is incomplete because it does not consider other effects at the same time or, to the extent that it leaves them open for discussion, it may introduce the measurement inconsistencies that it is attempting to eliminate from the existing situation.

Finally, it would be interesting to see evidence of how often and to what extent fair values would differ from historical cost in a typical entity, so as to be better able to assess the paper's usefulness and implications in practice.

Summarising our replies to several specific questions, especially questions 9, 14, 15, and 18, we would suggest the following basic rules:

Assets and liabilities should initially be measured at fair value if, and only if, they are traded on active and liquid markets.

Historical cost should be considered the best estimate for initial fair value unless there is persuasive evidence that fair value differs substantially from historical cost.

2. 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.*

We agree, but note that one might consider entry and exit value versions of fair value, too, because their underlying theoretical concepts differ. Paragraph 47 (condensed version) briefly mentions these, but does not elaborate.

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 comments 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)?*

Current cost is defined in paragraph 38 as: "The most economic cost of an asset or of its equivalent productive capacity or service potential." An alternative would be to replace "most economic cost" with "most advantageous cost", as this definition is used elsewhere.

Value in use: paragraph 45 states that the definition does not state whose expectations should be the basis for determining value in use. We agree, and suggest that this is amended in the definition of value in use (similar amendments are proposed for other measurement bases).

We believe it might be useful to include the market aspect in the definition of "fair" value, e.g., by considering a reference to mark-to-market measurement (see the discussion in paragraph 48). We also suggest including market value in the definition of fair value, e.g., by saying that fair value is market value or an approximation to it. See, e.g., the use of “market (fair) value” in paragraph 62 of the condensed version.

We agree with the other definitions.

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.

We agree.

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)?*

(a) We agree.

(b) We generally agree. We think that the definition of a market in paragraph 55 (condensed version) need not explicitly include the market rate of return, as this seems to be common to any market equilibrium.

(c) We agree.

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.*

We agree.

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 para-*

graphs 123-129 of the main discussion paper)? If not, please explain your views.

We agree, but wish to point out that entity-specific characteristics do play an important role from the management point of view, which under IFRS is no longer restricted to supplemental disclosure (see paragraph 61 of the condensed version), e.g., in the IAS 39 fair value option.

We also note that market discipline (paragraph 60 of the condensed version) is important only if it is an available option for management at the time the decision is taken or when the asset is recognised. This is particularly important under the additional considerations in paragraphs 179-180 of the condensed version.

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.

In theory, we agree there should be only one market value. In practice, markets are imperfect (otherwise there would be no need for accounting information!), and it may be possible that different markets exist (e.g., more or less liquid markets, accessibility). The paper concedes this in paragraphs 74-82. Hence, we suggest in the statement in paragraph 62 of the condensed version "can be only" should be replaced by "in most cases there should be only".

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.*

We agree because it follows from fair value as an exchange price between buyers and sellers of similar items (as noted in paragraph 143 of the main paper).

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.

(a) We generally agree, although a portfolio view conceptually introduces an entity-specific element into fair value, as a result of a management decision to acquire individual (separable) items together. A portfolio view seems acceptable if there is a market for such portfolios (although we believe that different prices on markets for individual assets and portfolios of the same assets would create arbitrage opportunities and indicate that the markets are imperfect). However, the term "portfolio" indicates that it is a set of similar individual (separable) items. For example, the proposal probably works well for portfolios of financial instruments. However, a "portfolio" is obviously different from a business combination, where the difference between the fair value of the consideration and the sum of the fair values of the assets and liabilities acquired is goodwill.

We believe the portfolio view is consistent with historical cost, though. Difficulties with the portfolio view, therefore, are similar to those identified for historical cost (e.g., the need for allocation, the different benchmarks for management evaluation).

(b) We find the proposal in paragraph 73 of the condensed version vacuous. It does not contribute to the definition of the boundaries of an asset or liability. It is almost entirely arbitrary how much one widens or narrows the focus. Consider the case of an integrated production line. One could consider the production line to contribute to the generation of future cash flows, but alternatively focus on each screw or piece of metal. If the generation of future cash flows is entity-specific, it again introduces an entity-specific element into fair value, which is contrary to its underlying concept. We believe a good way to set boundaries is on the basis of how transactions are commonly performed.

In general, we believe this discussion shows how difficult it is to be consistent with fair value as (theoretically speaking) the reflection of a hypothetical market transaction. Unlike actual transactions, it must take into account what might be assets in markets, before even considering their individual fair values.

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 or research you would think should be carried out.*

We agree with the suggestion, although we note that referring to the market in which the asset/liability was acquired/issued introduces an entity-specific element , which is at odds with the concept of fair value measurement.

We agree with the practical conclusion of the paper here, but believe the proper concept for this is the historical cost approach.

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.*

We agree that, in principle, transaction costs should not be part of fair value, envisaged as *the* price of actual or hypothetical transactions in a market. However, when it comes to initial measurement, we do not see why unavoidable transaction costs should not be part of the recognized amount of an asset. It does not seem plausible that they are expenses in the period the asset is acquired even if the asset itself contributes future cash flows over more than one period.

Transaction costs are a result of market imperfections or the cost of using the market. Ignoring them (if they are material) gives a biased view of the firm's operations and assets/liabilities, if fair value is considered as the opportunity cost of not trading them on the market (in which case exit transaction costs would have to be considered as well).

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.*

Both relevance and reliability are continuous measures. To a large extent, they are countervailing characteristics. Given that the objective is to provide the most useful information, we find it difficult to accept that the tradeoff is resolved by setting a threshold (however that might be determined) for reliability and maximising relevance. The maximum usefulness is a combination of both characteristics where the marginal change in both is exactly equal. We are aware that this is difficult in practice, but so is the definition of a threshold for reliability.

An objective ranking of alternative measures can only be made if two measures exhibit similar reliability but differ in relevance, or vice versa. Any other combination requires consideration of the relative changes in reliability and relevance.

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.*

We agree with the two sources of limitations.

The paper proposes that estimation uncertainty, but apparently not economic indeterminacy, requires supplemental disclosures. We do not see a reason for excluding economic indeterminacy, particularly because it requires assumptions that presumably can easily be stated.

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.*

We agree that, conceptually, fair value is a relevant measure at initial recognition although, as noted above, fair value includes entity-specific elements that create difficulties and practical difficulties obtain.

We also find it difficult to envisage how "acceptable reliability" is to be defined operationally.

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.

We agree. However, we wish to emphasise the practical difficulties in estimating fair value for most transactions for which no highly perfect market exists.

Most transactions are probably of the type indicated in paragraph 110 of the condensed version. We consider it difficult for management to argue that the fair value differs from the negotiated price, because any difference will impact on managerial performance measures or is a result of earnings management. We find it useful to take as an assumption the business judgment rule that management does its best, given the circumstances. (A similar assumption is the going concern assumption.)

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.

We generally agree with the analysis, but note a few details.

Paragraph 140 of the condensed version states that reproduction cost does not purport to measure value received, which it has in common with historical cost but also with fair value, since real or hypothetical market prices are marginal prices and do not indicate the highest value and best use of the asset (hence, we disagree with the statement in paragraph 143 of the condensed version).

Paragraph 154 of the condensed version summarises the use of current cost. We suggest distinguishing between reproduction and replacement cost in this statement (as it is done in paragraph 177 (a) of the condensed version).

In the analysis of net realisable value we miss a discussion of the relevant market. Indeed, it is conceivable that net realisable value could be higher than fair value.

Paragraph 169 (c) of the condensed version notes specifically that value in use cannot be estimated for assets used together (cash-generating units); however, we note a similar difficulty with the fair value of portfolios of assets and the level of aggregation of assets/liabilities.

We propose a more succinct definition of deprival value (see paragraph 189 of the condensed version): the lower of current cost and recoverable amount, with recoverable amount being the present value of the future net cash flows generated by the asset from its best use. The reason is that it may be optimal to sell the asset either immediately or at any point in time until the end of its useful life (which is again entity-specific); the current definition emphasizes the immediate sale only.

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 con-*

densed version and paragraph 417 of the main discussion paper)? If not, please explain why.

We agree.

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.*

We believe the proposed hierarchy will be difficult to apply in practice due to the complex and costly analysis that is required for each and every asset or liability recognised. We therefore suggest that initial measurement should start from the rebuttable assumption that historical cost is the best estimate of fair value at the time of the agreement, and only where there is persuasive evidence that fair value differs from historical cost it should be measured in other ways. These can be ranked following the proposed hierarchy (but excluding historical cost).

This would imply reference to historical costs not only in situations where they differ from fair values (see paragraph 122 of the condensed version).

In fact, this suggestion is related to what the paper states in paragraphs 135 and 185 of the condensed version, although we do not see it emphasised in the rest of the paper, in particular not in the proposed hierarchy. The difference is that paragraph 135 is dealing with practical considerations and existing standards and practices.

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.*

No.