Date

23 May 2006

Le Président

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Dear Mr. Enevoldsen,

Re: Draft EFRAG comment letter on IASB Discussion Paper "Measurement Bases for Financial Accounting – Measurement on Initial Recognition"

1. FEE (Fédération des Experts Comptables Européens, European Federation of Accountants) is pleased to submit its comments on EFRAG's preliminary views. EFRAG's draft comment letter on the Discussion Paper has been very helpful to us in our discussion of the document. Overall, we agree with EFRAG's draft letter.

2. We have some general remarks concerning the Discussion Paper. We regret that the paper focuses exclusively on initial measurement because we think the issues of initial measurement are closely linked to the subsequent measurement. Decisions taken at initial recognition impact the subsequent measurement. It is difficult to draw a conclusion on measurement at initial recognition without considering subsequent measurement by isolating both.

3. The paper seems to assume that for most assets or liabilities, there is a perfectly efficient market. This may be the case for certain classes of financial instruments but not for other assets. Some plants or equipment are specific to an entity and do not have individual market value. Also, the paper seems to consider that the fair value of a group of assets can be the sum of the values of the individual assets. This assumption is not relevant for non-financial instruments.

4. We think that a number of conclusions drawn in the paper are not well justified. The paper concludes that market value is superior to entity-specific measurement objectives based on unconvincing assertions without exploring why market value would be different from entity-specific value at the transaction date.

5. We disagree with the proposed treatment for transaction costs. We believe they should be included in the acquisition costs at initial recognition under both measurement objectives. Paragraph 35 of chapter 3 should address transaction costs as part of historical costs. Also it is not obvious to differentiate between recoverable in the market place or not because we believe transaction costs are specific to a transaction and influence the price paid. The discussion on transaction costs in paragraphs 86 – 87 is too limited as it does not address why transaction costs are not part of fair value on initial recognition. Also, the paper assumes that assets can be sold on the same market as they are bought but it is rarely the case. The exit market is not relevant to assess the recoverability of transaction costs.

6. We observed that the discussion paper confuses, especially in chapter 4, the objectives and the instruments suitable to reach those objectives. For example, market versus entity-specific measurement is not two distinct objectives of financial statements. As set out in the Framework, the objectives of accounting are "decision usefulness" as well as "stewardship" or "accountability of management". The use of measurement concepts and accounting policies is not an end in

itself but a means to fulfil the objectives of financial statements. Denominating the concepts analysed in chapter 4 of the discussion paper "objectives" is somehow misleading. The table set forth in paragraph 59 reveals this weakness. Whereas the left column depicts the objectives of financial accounting (and the qualitative characteristics), the headline purports to depict objectives, too. Instead, the market versus entity-specific distinction just applies to certain attributes of measurement concepts.

7. The various conclusions proposed in the paper will have an effect on the financial performance of entities. It is not clear what view of the entity's performance the paper wants to demonstrate. We are concerned about the loss of the current notion of entity's performance. The discussion about measurement is moving away from the concept of transaction and performance, by proposing a value at which the entity was supposed to acquire an asset and not the value at which it acquires it. An entity makes profit by buying something and selling it for more with a margin. This added value will presumably not be in the performance reporting but included in the initial value under the proposals. The conclusions of the paper raise several questions. Measuring at fair value raises the issue of when gains and losses have to be recognised. In particular, we would appreciate clarifying if a day-1-profit recognition would be recognised under the different valuation bases and also how to recognise the gain in a bargain transaction or the loss when the price is higher than the market. We believe initial measurement should be at the value of the asset or liability as it is when acquired or assumed, and not as it would be the day after or in another transaction.

8. We are not convinced by the arguments underlying some conclusions and by the implications of these conclusions. Some examples would have helped to demonstrate the difference between measurement bases. We believe that at initial recognition, they are likely to give the same value in most situations. An analysis of the reason for differences between measurement bases and the way to account for these differences would be a very valuable discussion, as well as a discussion on the cost or benefit of each concept of measurement.

9. Financial reporting must be practical if it is to be accepted and understood by users. Pilot tests, possibly including applying the concepts to actual companies, would assess the practicality of the Paper's proposals, identify problems to be addressed, and give an indication of the overall cost of implementation.

10. The Paper's proposals have significant long term implications for financial reporting in the future. Therefore, and having regard to our concerns highlighted above, we counsel against implementing these proposals in the short term, particularly without further consideration of the subsequent measurement of assets and liabilities and of the outcome of the performance reporting project.

11. Our comments on the answers to the questions raised in the Exposure Draft included in the appendix of EFRAG's letter are included in the appendix attached.

We would be pleased to discuss any aspect of this letter with you.

Yours sincerely,

David Devlin
President

Question 1 - 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.

EFRAG draft response:
The paper lists the following measurement bases: historical cost, current cost (i.e. reproduction cost and replacement cost), net realisable value, value in use, fair value and deprival value. We agree that the list is comprehensive.

FEE draft response:
We agree that the list is comprehensive. We suggest however to describe the bases with the perspective of achieving the reporting objective of decision usefulness.

Question 2 - 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)?

EFRAG draft response:
We have not analysed the terms, definitions and interpretations in sufficient detail yet to be able to reach detailed conclusions about them. However, based on our initial consideration, we do have a number of concerns:

(a) *Historical cost* - We note that paragraph 34 defines the historical cost of an asset as the fair value of the consideration given to acquire that asset at the time of the asset's acquisition. We are concerned about how the phrase "at the time of the asset's acquisition" might be interpreted when, say, the asset is being constructed over a period of time. We believe the historical cost of a constructed asset is the accumulated cost incurred in constructing that asset; in other words the aggregate of the fair value of each bit of consideration given (such fair value to be determined at the date that bit of consideration is given). However, we have seen it suggested that the date of acquisition of a constructed asset is the date it becomes operational, which would mean that under the paragraph 34 definition the historical cost of an asset that is constructed over a period of time would be the fair value—at that date the asset becomes operational—of the consideration given to build the asset. That is *not* in our view the historical cost of the asset.

(b) *Value-in-use* - Paragraph 44's definition of value-in-use does not make it clear whether value-in-use is to be based on entity-specific expectations of estimated future cash flows. Value-in-use is usually viewed as an entity-specific value but FASB's discussion (in its Fair Value Measurement Guidance draft standard) of the non-entity-specific 'fair value-in-use' means that can no longer be assumed to be the case.

(c) *Deprival value* - Paragraph 50 states that the term 'deprival value' is not defined or used in IASB standards. Although deprival value is not specifically mentioned in IFRS, it does underlie the principles in IAS 36.

(d) *Fair value* - The definition in paragraph 46 is the existing definition in IFRS for the fair value of an asset. However, as FASB's work on fair value measurement guidance has revealed, that definition says little about what exactly the notion of fair value is attempting to capture. Is it a market-based measure or, for example, an entity-specific measure? When there is more than one market, what exactly is it that fair value is attempting to reflect? (Or, in other words, which reference market should be used and why?) Is it about entry value or exit value? (We recognise that this issue could be viewed as a reference market issue as well.) According to some of the comments in the discussion paper, fair value is superior to other measurement bases only if these questions are answered in a particular way, which suggests that there is a need to define fair value more precisely before comparing it to other measurement bases.

Of course, if the paper defines fair value more precisely, it will also be necessary to extend the list of possible measurement bases identified in chapter 3 to include the versions of fair value that are not reflected in the more precise definition.

FEE draft response:
We agree with EFRAG's comment that the definition of historical costs is not appropriate and should cover constructed assets. The definition ignores the notion of accumulation of costs, for assets being constructed. We question, under the proposed definition, what the cost of an asset during the construction phase would be.

We do not consider deprival value as a measurement basis. It is a compound value. If deprival value is a measurement basis, then the recoverable amount should also be part of the list.

We support EFRAG's draft comment on the definition of fair value.

Question 3 - 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.

EFRAG draft response:
We agree that the main sources of the differences between the identified bases for measuring assets and liabilities on initial recognition are (a) the 'value-affecting properties and market sources' identified—the unit of account, the existence of different markets, information asymmetry, bid-ask spreads and transaction costs, and market accessibility and related issues—and (b) differences between market-based measures and entity-specific measures. It follows that those factors should be taken into account in the measurement debate. However, many of these factors seem to have been ignored, assumed away or not taken fully into account in the paper's analysis, reasoning and conclusions. This seems odd, not least because the only time that initial measurement is really interesting is when there are differences on initial recognition between the various possible measurement bases. For that reason we would have expected value-affecting properties and market sources to be at the centre of the debate.

Paragraph 62 of the condensed version of the paper states that an a priori expectation is that there would be only one fair value for an item on measurement date. Much of the subsequent discussion is then based on this expectation. Yet it is clear from the paper (see paragraph 137 of the longer version for example) that the authors have not been able to reconcile the view that there is only one fair value with the observable evidence.

The discussion of transactions costs in paragraphs 86 and 87 attempts to differentiate between transaction costs that are recoverable in the market place and transaction costs that are not. We do not think this differentiation as currently expressed in the paper is workable because the recoverability of costs would appear to be more about pricing flexibility than accounting measurement.

FEE draft response:
We agree with the two sources of differences between measurement bases but we would have expected the paper to discuss the reasons behind the differences between market-based measures and entity-specific measures at initial recognition. In practice, we suppose that different measurement bases would be equal. The analysis of the causes of differences at initial recognition would be an appropriate discussion for this paper. We also would have expected to see arguments to justify why market-specific measurement objective is superior to entity-specific measurement objective.

Question 4 - 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)?

EFRAG draft response:
We have no comment on question (a); 'market value measurement objective' is a new term to us and it seems reasonable that it should have whatever meaning the authors want it to have.

We note that paragraph 54 states that the market value measurement objective is reasoned from finance literature on market prices and efficient markets. We think it would have been useful had the paper gone on to explain why a convention made in finance literature is appropriate for financial reporting bearing in mind that in the real world the vast majority of markets are not efficient markets. In any event we understand that the convention is now recognised by finance theorists to be an over-simplification because even liquid markets incorporate a lot of other components, including rational and irrational bubbles and human behaviour (see Robert Schiller, Andrei Schleifer, Frank Knight etc).

We are broadly happy with the definition of 'market', although we think that much of the discussion in the paper assumes that an efficient market exists even though the definition is not of an efficient market.

Question (c) refers to paragraph 102 of the short version of the paper, which states that "the tentative conclusion developed in chapter 4 is that the market value measurement objective has important qualities that make it superior to an entity-specific measurement, at least on initial recognition. Also, it has been reasoned that the fundamental objective of fair value is to reflect the market value of an item on the measurement date. Hence, fair value must be considered more relevant than measurement bases that depend on entity-specific expectations, as long as it can be reliably measured." As explained below and in our general comments at the beginning of this appendix, we do not believe that the arguments used by the paper to justify the tentative conclusion summarised in this extract are persuasive.

FEE draft response:
We support EFRAG's draft comment on paragraph 54.

We broadly support the proposed definition of "market". We agree with EFRAG that the definition is not of an efficient market although the paper assumes it exists for most transactions.

As mentioned in our general comments, we do not believe the arguments in the paper are persuasive to justify the tentative conclusion mentioned in paragraph 102, that fair value is more relevant than entity-specific measurement bases.

Question 5 - 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.

EFRAG draft response:

We are broadly happy with the way paragraphs 57 and 58 characterise entity-specific measures. We have however noted a couple of issues that concern us.

(a) We believe that the extract from CON 7 describes market-based measures in over-simplified terms. For example, market-based prices are only spot prices, and simple economics suggests that spot prices are simply the marginal price that achieves market equilibrium between market participants that have different views as to the value of the asset or liability involved. A market-based measure of an item does not therefore reflect the value of the item from the perspective of all market participants, just its value to the 'marginal' market participant. We think it would be helpful to explain why the information provided to users is improved by using marginal values rather than amounts that are closer to the items' true economic worth.

(b) We think it is an oversimplification to characterise every measure as either market-based or entity-specific, because there is a category of data that is neither market-based nor entity-specific and we think that could lead to a category of measure that is also neither market-based nor entity-specific. For example, a manufacturer may have data about the failure rates of its products. Such information is not subjective—it can be verified by independent third parties—but is not information to which market participants generally have access. It follows that not all information that is not market-based is subjective.

FEE draft response:
The definition of entity-specific measurement objectives properly reflects entity-specific measurement objectives. However, it describes it in a simplistic way by exposing the reasons why market-based value would not be appropriate. Under this definition, we would argue that historical cost is not an entity-specific objective because there is no assumption made by management. We suggest that the paper elaborates on where to classify historical costs based on this definition.

Question 6 - 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.

EFRAG draft response:
We do not agree with the comparison of market and entity-specific measurement objectives. We commented earlier that we think much of the discussion of market and entity-specific measurement objectives is particularly guilty of this; indeed it appears to us that the efficient market assumption is fundamental to the conclusion reached. That does not mean that the conclusion is necessarily wrong—further analysis is necessary—but we suspect it might mean that the market value measurement objective will generally be more relevant than entity-specific measurement objectives only when there are efficient markets. That will be the case only rarely.

Generally speaking, we found this section of the paper disappointing because, rather than a discussion that focuses on the criteria identified in chapter 2 and uses those criteria to discuss the advantages and disadvantages of the two measurement objectives, the paper simply seems to assume, without explanation, 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.

FEE draft response:
We, like EFRAG, do not agree with the conclusion drawn from the comparison of market and entity-specific measurement objectives because it is drawn without any argument of why market value is superior to entity-specific. We found the table on paragraph 57 is not so helpful in justifying the conclusion or analysing how the characteristics relate to financial reporting usefulness. Also, we observed that reliability is not part of the criteria although it is a qualitative characteristic in the Framework.

Question 7

(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.

EFRAG draft response:
Our understanding of paragraphs 135-137 of the long version of the paper is that, although the authors believe there should be only one fair value for each asset or liability, they have not been able to reconcile this view with what they observe to be reality. That does not surprise us because, although market forces will eliminate differences between the prices on different markets if those markets are efficient, there will be inconsistencies between market prices based on inefficient markets.

The paper itself states (in paragraph 136 of the long version) that the proposal referred to in (b) is not correct.

FEE draft response:
We disagree with the assumption that there is only one market value for an asset or a liability on a measurement date. We agree with the proposed differences between market values but believe there are also other differences, for example the location of the market. We believe there could be different market value for identical assets at different market’s locations and with other different aspects of markets.

Question 8 - 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.

EFRAG draft response:
We are very uncomfortable about the possibility that changes in the reporting entity’s own credit risk should be reflected in the carrying amount of their liabilities. We recognise that this discomfort relates to subsequent re-measurement and some commentators will argue it has therefore no relevance to this paper, which deals only with initial measurement. However, we are not so sure.

We think we have heard all the arguments for taking changes in an entity’s own credit worthiness into account in arriving at fair value, but are still not persuaded that recognising such changes in the entity’s balance sheet and income statement would improve the quality of the information provided by those financial statements. This suggests to us that there might be some sort of fundamental weakness in the way the fair value debate is being approached. It even makes us wonder whether the question posed in question 8 is the right question to ask. This is another reason why a comprehensive global debate on measurement is needed.

FEE draft response:
We overall agree with the fact that the credit risk associated with a promise to pay enters into the determination of the fair value. However, we recognise that credit risk is an issue for subsequent measurement, which is not in the scope of this paper. Concerning subsequent measurement, we are concerned about the effects of accounting for an entity's own credit risk, and in particular the valuation of liability. Any deterioration in a debtor's creditworthiness could result in the recognition of a gain by that debtor when the fair value of its liabilities is perceived to have declined.

Question 9 - 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.

EFRAG draft response
If an entity buys a portfolio of instruments with the intention of holding that portfolio largely intact and then selling it, it seems reasonable that the unit of account on initial recognition and subsequently should be the portfolio of instruments. On the other hand, if the entity is acquiring individual instruments, bundling them together and selling them as portfolios (or buying portfolios, unbundling them and selling individual instruments), the unit of account issue will determine when the bundling/unbundling profit or loss is recognised. As explained in our opening general comments, we believe that to answer question (a) in a way that is consistent with other aspects of the chosen accounting model, we need to understand precisely what view of the entity's financial performance and financial position the paper believes the financial statements should portray. That is also true of the other questions asked here.

FEE draft response
We support EFRAG's response. We felt uneasy with this proposal on the unit of account because the consequences on any asset or liability are not clear and it focuses primarily on financial instruments. The issue is very linked to the debate on day-1-profit recognition, which is not part of this discussion paper. The appropriate unit of account would depend on when the entity decides to bundle items or unbundled portfolio.

Question 10 - 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.

EFRAG draft response
We agree that further thought is needed on this part of the paper because, as explained in our answer to question 7, it does not seem appropriate to base so much of the analysis in the paper on an assumption (that there is a single fair value) which observable evidence shows is not valid.

As explained in our opening general comments, it is difficult to comment on the specific detailed proposals in the paper on this issue until we understand precisely what view of the entity's financial performance and financial position the paper believes the financial statements should portray.

FEE draft response

We support EFRAG's response and agree that further research is needed to explore other ways of valuation and to explain the differences between measurement bases. Also, we would appreciate a discussion in the paper on when historical cost is seen as an appropriate measure, apart from being a substitute for fair value.

Question 11- 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.

EFRAG draft response

Chapter 3 of the paper contains what we consider to be a comprehensive list of all possible measurement bases. At that point the fair value is defined in fairly broad terms such that different treatments of transaction costs are possible. The paper goes on to narrow the meaning of the term 'fair value' such that transactions costs are not included. That seems to us to be reasonable as long as the chapter 3 list is then extended to include alternative versions of fair value that involve a different treatment of transaction costs. The paper would then be able to consider whether the claims it makes about fair value as narrowly defined (that it is the most relevant measurement basis for all assets and liabilities on initial recognition provided it can be measured reliably) are justified and justifiable.

As we have already made clear in our earlier answers, we think it is difficult to comment on many of the detailed proposals in the paper until we have a clearer understanding of what view of the entity's financial performance and financial position the paper believes the financial statements should portray. In the absence of such an understanding, we feel able to make only the following observations on the issues raised in the question:

- When an entity buys an asset that it intends to use until it is exhausted, that entity is concerned only about the total cost of that asset and the return it will make on that total cost. It is indifferent to which part of the cost is a transaction cost and which part is the consideration given for the asset itself. In such circumstances, the paper needs to explain more fully and more persuasively why its proposed treatment of transaction costs is appropriate. For example, is it that the authors believe that, although the reporting entity may be indifferent as to what makes up that total cost, users are not indifferent? Or is it, for example, that the authors' proposal is based on pragmatism?

- We commented in our response to question 3 on the difficulty in practice of implementing the paper's suggestion that one should distinguish between costs that are recoverable in the market place and other costs. The example given in the paper (paragraph 87) concerning import duties seems to be about pricing rather than anything of relevance to the selection of an appropriate measure.

FEE draft response

We share EFRAG's comment concerning the narrow meaning of fair value and the difficulty in distinguishing between recoverable costs and other transaction costs. We believe that conceptually transaction costs are assets and using fair value would not properly reflect this. Also, the paper seems to suggest transaction costs are excluded from fair value, but also from other value in the hierarchy. We do not agree with this idea because we believe transaction costs are part of historical costs which is, at least, acceptable as a substitute to fair value. We refer also to our general comments about transaction costs.

Question 12 - 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.

EFRAG draft response
Compared to the existing Framework, the paper places greater emphasis on 'relevance' than on 'reliability'. This - and the comments we made about stewardship and accountability at the beginning of this appendix in the first bullet of paragraph 3 of our general comments - shows that it is difficult to discuss any significant aspect of measurement in isolation, and why it is so important that a comprehensive debate takes place.

FEE draft response
We are concerned about the way the paper puts more emphasis on relevance than on reliability, compared to the Framework. Reliability is an important factor in selecting a measurement basis. No measurement basis can be relevant if it cannot be measured with a reasonable level of reliability.

Question 13 - 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.

EFRAG draft response
We broadly agree with this part of the paper.

In our view, in order to operationalise the reliability test it is necessary to reach some sort of broad agreement on what is meant by 'sufficiently reliable' because at the moment there are significant differences of view. The paper does not address this issue.

FEE draft response
We agree with this discussion in the paper.

Question 14 - 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.

EFRAG draft response
We do not believe the paper has made a sufficiently strong case for concluding 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).

We believe that one reasonable way that can be used to evaluate the various measurement bases is to focus on the gains and losses that arise under each basis and ask what those gains and losses tell users of the financial statements about the financial performance of the entity. The paper, for example, seems to be arguing in paragraph 124 (and earlier in paragraph 59) that gains and losses arising on assets and liabilities should be allocated to the performance statement(s) in such a way that those gains and losses arising from market movements are 'anticipated' (ie recognised immediately) and those gains and losses arising because the reporting entity's position is different from the market's should be recognised only as the entity's strengths and weaknesses give rise to above average and below average returns. This might make sense when efficient markets exist—there seems to be some logic in not anticipating gains and losses that arise from the entity's use of its strengths and weaknesses, although it is reasonable to ask why the decision-usefulness of the information is improved by recognising gains and losses arising from market movements immediately. It is however not clear that such an approach is appropriate in the 'real world' of inefficient markets. The issue should therefore be discussed in the context of such markets. EFRAG's very early view is that, in such circumstances, recognising assets and liabilities at fair value on initial recognition will result in measurement inadequacies and market imperfections being recognised as day one gains and losses and it is not clear why that improves the decision-usefulness of the information.

We recognise that some commentators would argue that the focus in the previous paragraph on the implications for the gains and losses being recognised is wrong; instead they would argue that under the asset and liability approach one simply measures all assets and liabilities at their fair value—because that assists in arriving at the overall value of the business and/or provides the best (ie market) expectation of future cash flows—and a performance reporting presentation should then be chosen that extracts as much useful information as possible out of the gains and losses recognised. If that is the view held by the authors, the paper would have been better had it explained that view. We note also that such a view:

- assumes that market *exit* value provides the best expectation of future cash flows and that, in our opinion, is an assumption that needs to be justified. We agree that a balance sheet prepared on a market exit value basis is probably a good indicator of a reporting entity's future cash flows if the entity is intending to (or is in the business of) selling its assets as soon as possible after the balance sheet date. However, most entities are not in that business; instead they nurture their assets and use them to generate cash flows in less direct ways.

- places considerable reliance on the performance reporting presentation's ability to extract useful information out of the fair value gains and losses being recognised; and

- highlights a much wider point which is that decisions about measurement should probably not be taken in isolation from decisions about presentation and disclosures, because changes to the measurement bases used might require changes to presentations used and disclosures provided to ensure that users can extract the information they need from the new basis.

FEE draft response

We support EFRAG's concerns. The paper has not convinced us that fair value is the most relevant measure in all cases (when it can be estimated reliably) and does not discuss the cost and constraints of applying fair value compared to its benefits. We believe the value in use would be more appropriate in some cases where the fair value would be irrelevant. When an entity has no intention to sell an asset, its value in use is more relevant than its fair value. We could accept fair value if an efficient market exists but this would rarely be the case in real practice. However, without a clear idea of what financial position and performance an entity should reflect it is difficult to conclude that fair value would be the most relevant measure.

Another topic not analysed in appropriate depth in the discussion paper is the cost-benefit-constraint: using fair value instead of historical cost on initial recognition would increase the cost of preparing financial statements considerably. Because historical cost has to be determined and considered in accounting anyway, e.g. simply by monitoring payment, the determination of fair value necessary under the model proposed by the discussion paper is always an additional step to be carried out by the entity therefore resulting in additional cost.

Question 15 - 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.

EFRAG draft response

We agree:

- that fair value on initial recognition is not capable of reliable estimation in some common situations;

- with the statement (in paragraph 106) that a few infrequent observable transactions do not necessarily constitute a market; and

- with the same paragraph's statement that a transaction price paid or received for an asset or liability will not necessarily be its fair value on initial recognition. However, even if it is decided that fair value is the appropriate initial measurement basis to use, we think that transaction price paid or received will often be a reasonable proxy when there is uncertainty over the fair value on initial recognition.

However, we do have some difficulty understanding exactly when the paper envisages that a substitute for fair value will be used. For example, if entities were required to measure in its consolidated financial statements all acquisitions of subsidiaries at the fair value of that acquiree (as proposed by the IASB in its Bus Coms 2 Exposure Draft), we think your paper would require us to select a substitute for fair value and we think that substitute could well be historical cost. If that is not the authors' intention, this aspect of the paper would benefit from greater clarity.

FEE draft response

We agree that fair value is not capable of reliable estimation in some common situations on initial recognition. We believe that a transaction price paid or received should be accepted as a proxy for its fair value on initial recognition, unless there is persuasive evidence that it is not. Our view is in accordance with paragraph 109 of the condensed version.

Question 16 - Do you agree with the paper's analyses and conclusions with respect to the comparative relevance and reliability of:

- **historical cost (see paragraphs 120-137 of the condensed version and paragraphs 281-319 of the main discussion paper);**

- **current cost - reproduction cost and replacement cost (see paragraphs 138-154 of the condensed version and paragraphs 320-361 of the main discussion paper);**

- **net realizable value (see paragraphs 155-161 of the condensed version and paragraphs 362-375 of the main discussion paper);**

- **value in use (see paragraphs 162-169 of the condensed version and paragraphs 376-392 of the main discussion paper); and**

- **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.

EFRAG draft response

We had a lot of difficulty with this part of the paper because we think its tone, language and drafting generally is not neutral. In our view, the strengths of fair value and weaknesses of historical cost are overstated and the weaknesses of fair value and strengths of historical cost are understated. If one looks beyond this and takes into account that usually there will not be an efficient market for the asset or liability involved, it seems to us that the arguments used are not very convincing. In particular, the arguments for rejecting historical cost as a surrogate for fair value on initial recognition seemed to us to be fundamentally flawed. As we have already mentioned, the debate about whether to use historical cost or fair value for initial measurement purposes is only a real issue when the amounts are different, so we would have expected the paper to have analysed the reasons for the difference before reaching the conclusions it has, but it does not.

We also note that the paper appears not to be consistent in the way that it uses the term 'entity-specific'. Although historical cost is an entity-specific measure, it is different from other entity-specific measures and the arguments used in the paper to dismiss entity-specific measures do not in the main appear to us to apply to historical cost.

FEE draft response

We share EFRAG's views. The paper would have benefited from a discussion on the pros and cons of fair value and historical cost, and an analysis of the reasons for the differences between the two values. It only indicates weaknesses of each measurement basis compared to fair value. Theoretically, we would expect fair value and historical cost to be similar in an efficient market. We disagree with the position taken against historical cost in the paper.

We agree with EFRAG that historical cost is different from other entity-specific measures. It is not influenced by management intention.

Question 17 - 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.

EFRAG draft response
We do not think the issue is as simple as the paper suggests. We suspect that, when it is not possible to estimate a fair value reliably, fair value may actually not be the most relevant measurement basis either. That is because the markets will usually be fairly inefficient and in such circumstances the arguments advanced to support the superior relevance of fair value may not apply.

FEE draft response
We support EFRAG's comment. It is rather theoretical to present the issue as simple as that. For example, it has yet to be proven that transaction costs cannot be capitalised when other measurement bases are used as substitutes for fair value.

Question 18 - 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.

EFRAG draft response

We have no comment on the proposed hierarchy at this stage except to note that the discussion of the proposed hierarchy makes:

- no mention of transaction costs; and
- little reference to the discussion of the value-affecting properties.

FEE draft response
We do not agree with the proposed hierarchy because of the arguments discussed earlier in this letter, especially:
- fair value is not always the most relevant measure,
- historical cost is not given appropriate credibility (is presented below replacement cost and reproduction cost),
- transaction costs are not dealt with,
- no cost / benefit analysis.

We would prefer to see historical cost as higher relevance than current cost. The estimation techniques (Level 2 or 4) should only be used when benefits overtake costs.

Question 19 - 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.

EFRAG draft response
We agree with the statement made in the long version of the discussion paper that it is important to consider any capital maintenance implications of particular measurement bases. In addition to this we wonder whether it is appropriate to evaluate different measurement bases without first reaching conclusions on the underlying capital maintenance concept to be followed.

FEE draft response

We suggest that the debate on measurement be considered together with the project on performance reporting.