

23 February 2006

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London
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Dear David

A comprehensive global debate on measurement

The Technical Expert Group of the European Financial Reporting Advisory Group (EFRAG) has asked me to write to you on its behalf to say that we were delighted to read, in your statement of 31 January 2006 to the Economic and Monetary Affairs Committee of the European Parliament, that the IASB is instigating a comprehensive global debate on measurement and that this debate will include a consideration of the benefits of the range of measurement attributes and when each attribute should be used. We too believe that a comprehensive and global debate on measurement is now needed.

We suspect that there are plenty of misunderstandings and misconceptions about measurement, and that the debate could achieve much by helping commentators to develop a better understanding of each other's thinking and concerns. With that thought in mind, we have set out in the appendix to this letter some issues that we believe puzzle many commentators about the debate to date. It would be good if these issues could be addressed.

We want also to mention a potential concern that we have about the timetable for the debate. Measurement issues are at the core of many of the longer-duration projects on which the IASB is now working (including, for example, the projects considering revisions to IFRS 3 and IAS 37, and the fair value measurement guidance project). Many of these projects will determine the direction in which accounting will develop. We think it would be inappropriate for the IASB to publish any *major* new proposals or standards on measurement before the comprehensive measurement debate has taken place. Although we have argued before that the IASB should resolve framework issues before bringing forward proposals for standards that make assumptions about how those framework issues will be resolved, we understand that the IASB does not agree with this point of view. However, on measurement the issues involved are so fundamental and the concerns, misunderstandings, etc so great that we suspect that it would not be possible for the IASB to win acceptance for any such proposals or standards until the underlying fundamental issues have been resolved.

- It could be argued that the recently published Candian paper has already started the debate. However, that paper is incomplete—it deals only with measurement on initial recognition—and our initial view is that it appears to make too many

assumptions and assertions—or at the very least does not explain persuasively the reasoning underlying the conclusions reached.

- The work that FASB and the IASB are carrying out on what is fair value is also important but, unless it addresses the sort of fundamental issues mentioned in the appendix its main contribution to the comprehensive debate seems likely to be limited to clarifying some of the terminology currently used.

Finally, we would like to make clear to you that we stand ready to help the IASB in any way we can to ensure that the measurement debate is global, comprehensive, useful and, ultimately, decisive. Therefore, if there is anything you wish us to do you have only to ask. (As you know, this offer also applies to all other projects on your work programme.)

We hope that you find the comments in this letter helpful. If you wish to discuss it further, please do not hesitate to contact Paul Ebling or myself.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix:

Issues that we believe should be addressed in the measurement debate

Phase A of the Conceptual Framework project

- 1 The IASB and FASB are due to issue in the next few months an exposure draft on the Phase A of their Framework project, which deals with the objectives of financial reporting and the qualitative characteristics of financial information. There are two issues that this exposure draft will address which some commentators believe the two Boards' have got wrong and could well have significant implications for the measurement debate. It therefore seems important that the issues—and their possible implications for the measurement debate—are discussed fully in that exposure draft—or sooner if possible—so that they cannot be used later as reasons for continued differences of view about measurement. The issues are:
 - (a) *Whether stewardship and accountability are a separate objective of financial reporting or part of the decision-usefulness objective*—The two Boards have discussed this issue on several occasions now, and have tentatively concluded that stewardship and accountability are not a separate objective. It is clear though that some commentators do not agree.
 - (b) *The replacement of the 'reliability' qualitative characteristic with 'faithful representation'*—The two Boards have taken the tentative decision to replace the 'reliability' qualitative characteristic with 'faithful representation'. As far as we can judge, this is seen by the two Boards as a minor bit of tidying up, but many commentators do not see it like that and are concerned about the potential change.
 - (i) Although 'reliability' has always been described in the Frameworks as something that is more complex than the dictionary definition of 'reliability', that is not how most commentators have tended to use the term; in their view the term is about how 'soft' and subjective the information is. Viewed from their perspective, replacing 'reliability' with 'representationally faithful' is not a minor tidying up sort of amendment—it is a fundamental change that could have significant implications for measurement.
 - (ii) It is clear that many commentators are not sure what 'faithful representation' means, nor how the characteristic will be applied. It is important that this is fully addressed in the exposure draft.

What view are we trying to portray of financial performance and financial position?

- 2 It is clear that many commentators are so far unconvinced by the arguments that have been advanced in favour of up-to-date (ie 'current') value in general and market-based current exit value (henceforth 'fair value') in particular. In their view, the analysis used to support such measures is often flawed or superficial and involves unjustified assertions.

- 3 For example, some commentators think that the Boards assume when assessing the relevance of market-based current value measures that:
- (a) efficient markets with low transaction costs exist for all assets and liabilities, and
 - (b) market inefficiencies affect the reliability but not the relevance of such measures.

Such commentators point out that efficient markets with low transaction costs are rare, and that the existence of market imperfections considerably weakens the arguments used to support the relevance of such measures.

Some other commentators believe that the Boards do not assume the existence of efficient markets but have concluded that the usefulness of information is maximised by using measures that are estimates of what the efficient market price would be. Such commentators do not however understand why that conclusion has been reached (if it has been reached).

- 4 Take another example of what some commentators see as oversimplified analysis: it would appear that some supporters of fair value use the following logic to justify that support:

The objective of financial statements is to provide users with information about future cash flows...

...and current value tells users more about future cash flows than historical cost measures.

And a current exit value tells users more about future cash flows than a current entry value.

Subjectivity can be an issue with some forms of current value, so it is best to use as much observable data as possible.

That means using market-based measures.

Such an argument, some commentators suggest, treats all current value systems as the same when different current values result in different gains and losses being recognised, and therefore provide different views of the financial performance of the reporting entity. Such commentators believe therefore that it is important, when debating measurement, to reach a common understanding of the view of financial performance and financial position that the financial statements should be portraying. For example:

- (a) we have seen it argued by some commentators that the effect of adopting a fair value measurement approach is that gains and losses arising on assets and liabilities are allocated to the performance statement(s) in such a way that the gains and losses arising from market movements are 'anticipated' (ie recognised immediately) and the gains and losses arising because the reporting entity's position is different from the market's are recognised only as the entity's strengths and weaknesses give rise to above average and below average returns. This allocation, it is argued, is appropriate because gains and losses that arise from the entity's use of its strengths and weaknesses should not be recognised before those strengths and weaknesses have been utilised.

Such arguments seem worth exploring further within the context of 'real world' situations (ie inefficient markets with significant transaction costs) because they might help us to understand better which approach (or approaches) best meet the objectives of financial reporting.

- (b) if an entity buys individual instruments with the intention of bundling them together and selling them as portfolios (or alternatively buys portfolios with the intention of unbundling them and selling individual instruments), the unit of account issue will determine when the 'bundling'/'unbundling' gain or loss is recognised. This is not a minor technical issue; it goes to the core of what financial reporting is all about and therefore needs to be resolved by considering that fundamental issue.
- 5 Some commentators do not accept the argument, mentioned in paragraph 4 above, that current exit values tell users more about future cash flows than other measures. Some, for example, argue that one of the key pieces of information that users are interested in is information about the reporting entity's ability to generate future cash inflows that will exceed its future cash outflows and it is not self-evident that using current exit value is best at portraying that ability. (That does not mean necessarily that such values are not better at portraying that ability than historical cost measures, merely that the case needs to be made.)
- 6 Some commentators argue that this focus on gains and losses is wrong; instead one should simply seek to measure each asset and liability at the amount that best reflects its current value and should then rely on an appropriate performance reporting presentation to extract as much useful information as possible out of the resulting gains and losses. Such an argument highlights:
- (a) the general point that decisions about measurement bases should probably not be taken in isolation from decisions about presentation and disclosure.
 - (b) the reliance placed on the performance reporting presentation's ability to extract useful information out of the gains and losses being recognised. Some commentators believe that such reliance is premature until the two Boards have made further progress on the disaggregation of fair value gains and losses.

Terminology

- 7 It has been a source of frustration to some commentators that some standard-setters have felt able to make general statements as to the superiority of fair value measures before they have decided exactly what fair value should mean. Presumably the standard-setters involved believe fair value is superior however it is defined, but that is not self-evident to many other commentators. It is important that definitions and methodologies are addressed early in the debate.

Other issues

- 8 Fair value as defined by FASB in the working draft of its Fair Value Measurement standard is a spot price. Spot prices are of course 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. It would be helpful if the debate could explore why spot prices provide the most relevant information for users.

- 9 The recent Canadian-prepared paper characterised every measure as either market-based or entity-specific. Similarly, the hierarchy in the FASB draft standard characterises inputs as either market-based or non-market based. Some commentators believe such characterisations are simplistic because there is a category of data that is neither market-based nor entity-specific and that could lead to a category of measure that is also neither market-based nor entity-specific. It would be useful if this too could be considered.
- 10 We are very uncomfortable about the possibility that changes in the reporting entity's own credit risk (or, to be exact, changes in the credit rating attached to the reporting entity's own instruments) would be reflected in the carrying amount of their liabilities. That is primarily because we are not yet persuaded that recognising the effect of such changes in the entity's balance sheet and income statement would improve the quality of the information provided by those financial statements. (We understand users will usually reverse out of the income statement the gains and losses arising from changes in own-credit risk. That suggests to us that users do not find those components of performance useful; which in turn suggests that maybe they should not be in the income statement in the first place.) On the other hand, we recognise that it is argued that own-credit risk has to be taken into account if economically similar instruments are to be carried in the balance sheet at the same amount. It is worth considering whether that is a valid argument—are the instruments really as similar as is sometimes suggested—but if it is it means at least some of the technical arguments point in the opposite direction to user needs. That suggests that something is wrong and that we need to ask ourselves whether there might be some sort of fundamental weakness in the way we are approaching the debate and analysing the issues.