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Dear Sirs,

Comments on the Discussion Paper "Measurement Bases for Financial Accounting—Measurement on Initial Recognition"

The Accounting Standards Board of Japan (ASBJ) is pleased to comment on the Discussion Paper "Measurement Bases for Financial Accounting—Measurement on Initial Recognition". The views expressed in this letter are those of International Issues Standing Committee of the ASBJ.

Ⅰ General view

1. Comment on the basic concept of the discussion paper

(1) Premise of the law of one price (Q7)

The paper is based on the premise that there can be only one market (fair) value for an asset or liability on any measurement date (paragraph 135 of the main paper). In our understanding, the paper is based on the premise that the law of one price works for all assets and liabilities. However, as shown in reference to the issues of the unit of account and the reference markets in paragraph 137 of the main paper, it is unrealistic from the practical viewpoint to suppose that all assets and liabilities have only one market price.

(2) Proposal that fair value is the most relevant measurement base on initial recognition (Q6, 14 and 15)

The paper suggests that a transaction price paid or received for an asset or liability should not be described as its fair value on initial recognition unless there is persuasive evidence (paragraphs 243-252 of the main paper) and that fair value is more relevant than measurement bases depending on entity-specific expectations (paragraph 128 of the main paper). Therefore, in our understanding, the paper proposes that measurement objectives depending on entity-specific expectations should be eliminated and that all assets and liabilities should be measured at their fair value on initial recognition rather than the consideration an entity actually pays or receives, on the ground that fair value is the most relevant measurement base for an asset and liability on initial recognition. As a result, gains or losses will be recognized when the market value on initial recognition differs from the amount paid to acquire an asset or received in exchange for a liability (paragraph 122 of the main paper).

However, we do not agree with this proposal. A transaction price, unlike measurement bases depending on entity-specific expectations, represents the initial investment cost which becomes the basis for the expectation. From the viewpoint that profit or loss is calculation of the actual return on the invested cost, we believe that acquired assets should be measured at the amount paid on initial recognition and that assumed liabilities should be measured at the received amount or amount to be paid.

Even when fair value differs from historical cost (for example, in the case of fixed-price contracts or self-constructed assets), we believe that historical cost should be prioritized and recognition of gain or loss on initial recognition should be avoided. However, only when the transaction price is unusual and significantly differs from fair value, fair value should be used as measurement objective on initial recognition and it would be unavoidable to recognize gain or loss on initial recognition.

(3) Disregard of the viewpoint of the computation of income

Although measurement of assets and liabilities greatly affects the computation of income, the paper, focusing only on measurement of assets and liabilities, disregards the viewpoint of computation of income as the basis for estimates of the corporate value. In reality, the sum of the fair values of individual identifiable assets and liabilities would never be equal to the total value of the entity, because markets are not complete for some of the assets and liabilities such as entity-specific intangible assets. Accordingly, information of profit or loss is essential in estimating the corporate value and profit or loss calculated by measuring all assets and liabilities at their fair value would not be useful for investors.

(4) Focus only on the measurement objective on initial recognition

The paper exclusively addresses the measurement objective on initial recognition and it explains that subsequent stages will analyze alternative bases for re-measurement of existing assets and liabilities (paragraph 16 of the main paper). However, since there is not a clean division between initial recognition and re-measurement, as described in paragraph 21 of the main paper, we do not believe that discussion focusing only on measurement on initial recognition is productive.

2. ASBJ’s fundamental view on the measurement of assets and liabilities

(1) Classification between financial investments and non-financial investments

The objective of financial reporting is to disclose information that provides the basis for assessment of corporate value, in other words, information including financial positions and operating results of the entity to help investors in assessing the value of the entity by forecasting future cash flows. We classify assets and liabilities into financial investments and non-financial (business) investments according to the purpose of the investments, in order to disclose accounting information useful for investors' decision-making. We consider the measurement objective should be determined according to whether the purpose of the investment is financial or non-financial.

(2) Non-financial investments

Non-financial investments such as property, plant and equipment, and inventories, are investments for which disposals are constrained by business objectives and that are aimed at obtaining the results through operating the business. In the case of non-financial investments, the result that should be compared with the ex ante expectation is obtention of cash or its equivalent through operating the business, not changes in the market price. Therefore, recognition of profit or loss should be based on that fact, not on marked to market measurement. For example, an item of property, plant and equipment is measured at historical cost less accumulated depreciation, and profit or loss is calculated based on such measurement.

(3) Financial investments

On the other hand, financial investments such as securities held for trading and derivatives are investments for which disposals are not constrained by business objectives and that are aimed at obtaining gains from changes in the market price. In the case of financial investments, the result that should be compared with the ex ante expectation is a change in the market price. Therefore, recognition of profit or loss should be based on that fact and profit or loss should be calculated based on marked to market measurement.

(4) Comment on the example on the measurement date on initial recognition (Q14)

The example in paragraph 411 of the main paper proposes to measure a truck at the fair value of 1100 on March 1 when delivery is to be made, rather than the fair value of 1000 on January 1 when an entity enters into a contract to purchase the truck, and to recognize a gain of 100 as the difference between the fair value of 1100 and the amount paid of 1000. In the case of financial investments, it would not be problematic to recognize gain or loss on initial recognition since a market could exist where net cash settlement is possible. However, we do not consider it relevant to recognize gain at the date a truck is acquired when an entity entered into a contract to purchase it for the purpose of the non-financial investment. In the case of non-financial investments, it would be inappropriate to recognize gain or loss immediately at the date assets are acquired, because the market where net cash settlement is possible does not exist. Therefore, the truck should be measured at the historical cost of 1000 on initial recognition. In the calculation of profit or loss for non-financial investments, results of the investment should be considered to have been achieved when cash or its equivalent is obtained in excess of the actual amount paid on initial recognition (i.e., historical cost), in other words, when the entity's expectation has transformed into the fact.

(5) Conclusion

The proposal of the discussion paper that fair value is the most relevant for the measurement objective on initial recognition, on the premise of the law of one price, seems to imply that all assets and liabilities should be treated like financial investments. However, we do not consider it realistic to premise the law of one price for all assets and liabilities. We believe that measurement of assets and liabilities according to their purposes of investment (i.e., measuring non-financial investments at historical cost and financial investments at fair value on initial recognition) and computation of income based on such measurement would provide more useful information for investors' decision-making than the proposal of the paper.

Ⅱ Detail issues in the Discussion Paper

1. Definition of fair value (Q1 and 2)

While the definition of fair value is not limited to either of an entry price or an exit price in the discussion paper (paragraph 89 of the main paper), the FASB exposure draft "Fair Value Measurement" defines fair value based on the exit price concept. We consider it necessary for the paper to clarify the view on the FASB exposure draft.

2. Premise of the law of one price (Q7)

We do not agree with the premise that there can be only one market (fair) value for an asset or liability on any measurement date.

(See **Ⅰ General view 1. (1) Premise of the law of one price)**

3. Credit risk associated with a promise to pay (Q8)

We agree that measuring financial liabilities on initial recognition without reflecting own credit risk would lead to unreasonable results. However, we would like to express significant concern about inclusion of effects of changes in an entity's credit risk in re-measurement of liabilities, although re-measurement issues are beyond the scope of this paper.

(See **Ⅰ General view 1.(4) Focus only on the measurement objective on initial recognition**)

The reasons are as follows:

- ■ Measurement based on the entity's own creditworthiness would be inconsistent with the fact that entities intend to satisfy all liabilities in full on the premise of the going concern.
- ■ A decline in an entity's creditworthiness would generally occur at the same time as a deterioration in the value of an unrecognized asset (i.e. internally generated goodwill). Because the deterioration in their value is not reported as an expense, it would be misleading to recognize only income relating to

the effect on liabilities.

- Adjustments for own creditworthiness are irrelevant unless an entity can realize gain by transferring the liabilities to the third party. For example, in the case of a non-marketable loan payable, we cannot suppose a situation where gain from a decrease in its fair value due to an increase of credit risk could be realized.
- In many cases, adjustments for own creditworthiness are not reliably measurable.

4. Transaction costs (Q11)

The paper proposes that transaction costs are not part of the fair value of an asset or liability on initial recognition, on the ground that they are not recoverable (paragraph 194 of the main paper and paragraph C16 of Appendix C). However, for non-financial investments, we believe that transaction costs should be included into historical cost on initial recognition and that historical cost is usually more relevant than fair value as the measurement objective on initial recognition.

The reasons are as follows:

- The values of non-financial investments are not equal to their fair values, and differ depending upon which entities hold them. As currently prescribed in IAS 2 "Inventories"[1] and IAS 16 "Property, Plant and Equipment"[2], historical costs of non-financial investments should include transaction costs which are directly attributable to acquisition, from the viewpoint that profit or loss is calculation of actual return on the invested costs.
- Paragraph 16 of IAS 16 "Property, Plant and Equipment" provides that the cost of an item of property, plant and equipment comprises not only directly attributable costs, but also initial estimate of the costs of dismantling, removing and restoring items (costs for asset retirement). If an item of property, plant and equipment were measured at fair value on initial recognition, inclusion of costs for asset retirement in its initial recognition amount would become unexplainable, because costs for asset retirement are future cash outflows and become negative component of fair value. Accordingly, capitalization of costs for asset retirement would be impossible without the historical cost concept.
- Although the alternative accounting treatment to capitalize borrowing costs under IAS 23 "Borrowing costs" is based on the historical cost concept, capitalizing only borrowing costs would be unexplainable from the fair value perspective. The paper, in our understanding, proposes that cost of capital, including cost of equity, should be reflected to the initial recognition amount of assets under construction (paragraphs C4-14 of Appendix C). We cannot support such method of capitalizing cost of capital, because it would result in only excess return over cost of capital being included in profit and profit computed in that manner would be inconsistent unless cost of capital is reflected to the initial recognition amount of all investments.

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[1] Paragraph 11 states that the costs of purchase of inventories comprise transport, handling and other costs directly attributable to acquisition of finished goods, materials and services.

[2] Paragraph 16 states that the cost of an item of property, plant and equipment comprises any costs directly attributable to acquisition.

5. Proposal that fair value is the most relevant measurement base on initial recognition (Q14)

We do not agree that fair value is the most relevant measurement base for an asset and liability on initial recognition. As far as a transaction price does not differ significantly from fair value, we believe that acquired assets, in principle, should be measured at the amount paid on initial recognition and that assumed liabilities should be measured at the received amount or the amount to be paid. (See Ⅰ **General view 1.(2) Proposal that fair value is the most relevant measurement base on initial recognition)**

6. Statement that a single transaction exchange price should not be accepted to be equal to fair value unless there is persuasive evidence that it is (Q15)

We disagree with the above statement of the paper, because it indicates that fair value is prioritized over the transaction exchange price which an entity has actually paid.

The reasons for our objection are as follows:

- The definition of fair value that states "the amount for which an asset or liability could be exchanged between knowledgeable, willing parties in an arm's length transaction" (paragraph 88 of the main paper) is considered to be based on the premise of the law of one price. Nevertheless, it is proposed that a single transaction exchange price should not be accepted to be equal to fair value. It appears to be inconsistent with the abovementioned premise.
- The paper admits that in many situations it will be reasonable to assume that the transaction price exchanged for an asset or a liability reasonably reflects its market value on the transaction date (paragraph 247 of the main paper). We consider that the statement that a single transaction exchange price should not be accepted to be equal to fair value overemphasizes the exceptional situation where the transaction price differs significantly from fair value.
- We consider that historical cost as a substitute in Level 3 of the proposed measurement hierarchy would be anyway used for entity-specific assets and liabilities for which there is no market on initial recognition. In addition, we have concern that there could be possibility of profit manipulation if fair value were prioritized. For example, when the transaction price of inventories (raw materials) exceptionally differs from fair value, it would be possible to manipulate the profit through purchasing inventories in large quantity and holding them as stock, because the difference between the amount paid and fair value would be recognized as gain in accordance with the proposal of the paper.
- The exposure drafts "Business Combinations" of the IASB and the FASB state, "…in the absence of evidence to the contrary, the exchange price (the consideration transferred) paid by the acquirer on the acquisition date is presumed be the best evidence of the acquisition-date fair value of the acquirer's interest in the acquiree." In business combinations, an overpayment and a bargain purchase is considered to occur only in exceptional cases. Therefore, in the example in paragraphs 248-249 of the main paper, we consider that there is no other way but to suppose that fair value of the subsidiary

is 1.35 million which the entity A paid, because a market for shares of the unlisted company does not exist.

7. Paper's analyses and conclusions with respect to the comparative relevance and reliability of measurement bases (Q16)

The paper concludes that fair value is the most relevant measurement objective on initial recognition, comparing it with historical cost, current cost, net realizable value, value in use and deprival value. However, we do not consider it useful to compare the six possible measurement objectives only in the aspect of measurement on initial recognition. We believe that the choice of the most relevant measurement objective should be made according to not only the timing of measurement (initial recognition or re-measurement) but also situations of the assets or liabilities to be measured.

The objective of financial reporting is to disclose information that provides the basis for assessment of corporate value, in other words, information including financial positions and operating results of the entity to help investors in assessing the investment value by forecasting future cash flows. We believe that any single measurement objective is not sufficient to achieve such objective of financial reporting, and that measurement objectives need to be chosen according to the purposes of the investments[3]. Therefore, we do not believe that elimination of the measurement objectives other than fair value would help the achievement of the objective of financial reporting. We believe that the most relevant measurement objective differs according to the purposes of the investments, more specifically, as for the measurement objective on initial recognition, historical cost is most relevant for non-financial investments and fair value is most relevant for financial investments.

8. Proposed hierarchy for the measurement of assets and liabilities on initial recognition (Q17 and 18)

We do not agree with the proposed hierarchy for the measurement of assets and liabilities on initial recognition that gives the top priority to fair value as Level 1.

We believe that historical cost should be prioritized as the measurement objective for non-financial investments, although fair value is relevant for financial investments.

We hope that our comments will contribute to the debate on measurement bases.

Best Regards,

Ikuo Nishikawa

[3] As for impairment, there is a case where value in use is used as the measurement attribute for assets. The higher of value in use and fair value less costs to sell (net realizable value) is used as recoverable amount for impairment, as stated in IAS 36. Replacement costs and net realizable values are used as the measurement attribute for inventories applied for the lower of the cost or market.

Chairman, International Issues Standing Committee
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