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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **25 May 2006, London**

Project: **Fair Value Measurements (Agenda Paper 8F)**

Transaction and transportation costs in measuring fair value

INTRODUCTION

1 This paper examines the definitions and treatments of transaction and related costs in the:

(a) Current working draft of the FASB's Fair Value Measurement statement (the draft FVM statement),

(b) existing IFRSs,

(c) and the Discussion Paper on Measurement Bases for Financial Reporting: Measurement on Initial Recognition authored by the staff of the Canadian Accounting Standards Board (the Canadian paper).

2 Consistent with the draft FVM statement, the Staff recommends transaction costs be excluded from fair value as the Staff concludes these are attributes of the transaction, not of the asset or liability being measured. Additionally, consistent with the draft FVM statement, the Staff also recommends transportation costs be included in the fair value measurement to the extent they are an attribute of the asset or liability.

However, the Staff considers transportation costs in the broader context of value affecting properties of assets and liabilities. While the Staff fully agrees with the FASB's position in the draft FVM statement, the Staff concludes the discussion on value affecting properties, including transportation costs, could be more robust. As such, the Staff recommends a question be added to the invitation to comment asking respondents whether there is sufficient guidance in the exposure draft regarding the concept of value affecting properties (such as transportation costs and the specific location and condition of the asset).

3 This paper is organized in the following order:

(a) Definitions and treatments in the draft FVM statement.

(b) Definitions and treatments in existing IFRSs.

(c) Definitions and treatments in Canadian paper.

(d) Staff analysis and recommendations to the Board.

DEFINITIONS AND TREATMENTS IN DRAFT FVM STATEMENT

4 The draft FVM statement defines transaction costs as the incremental direct costs to transact in the principal or most advantageous market (paragraph 10 of the draft FVM statement). Incremental direct costs are costs that result directly from, and are essential to, a transaction involving an asset (or liability). Incremental direct costs are costs that would not be incurred by the entity if the decision to sell or dispose of the asset (or transfer the liability) was not made (footnote 5 of the draft FVM statement).

5 As discussed in Agenda Paper 8C, for purpose of determining the most advantageous market for the asset or liability, the amount in the respective market shall include transaction costs and transportation costs. However, transaction costs and transportation costs are treated differently when measuring the fair value.

6 In the draft FVM statement, the FASB concluded the fair value measurement of the asset or liability shall include only those costs that are an attribute of the asset or liability. The FASB concluded transaction costs are an attribute of the transaction, not

an attribute of the asset or liability. Therefore the fair value measurement of the asset or liability shall not include transaction costs[1].

7 However, the fair value of the asset or liability shall include costs that are attributes of the asset or liability. Transportation costs differ depending on the location of the asset (for example, a commodity in a remote location versus the same commodity located near the principle market). Therefore, the FASB concluded that in situations in which the location of an asset or liability is an attribute of the asset or liability the price in the fair value measurement shall include transportation costs.

8 The draft FVM statement is silent on how to identify and separate the transaction cost from those costs that are attributes of the asset or liability, though limited guidance will be included in the implementation guidance. Additionally, the draft FVM statement does not contain additional discussion of the types of items that are attributes of assets and liabilities versus those that are not.

DEFINITIONS AND TREATMENTS IN EXISTING IFRS

9 Within IFRS there are four similar terms that describe transaction type costs when measuring fair value. However, the definitions of the terms are not entirely consistent. The terms are as follows (note – for purposes of this paper, the following terms will be collectively referred to as "transaction type costs"):

(a) "Costs to sell" are defined by IFRS 5 (Appendix A) as "the incremental costs directly attributable to disposal of an asset (or disposal group), excluding the finance costs and income tax expenses"

(b) "Costs of disposal" are defined by IAS 36 (Par. 6) as" the incremental costs directly attributable to disposal of an asset or cash-generating unit, excluding the finance costs and income tax expenses". Examples of cost of disposal are legal costs, stamp duty and similar transaction taxes, costs of removing the asset, and direct incremental costs to bring an asset into condition for its sale (Par.28).

[1] The draft FVM statement indicates transaction costs should be accounted for in accordance with the provisions of other applicable accounting pronouncements. As such, the recognition of transaction costs is not discussed in the draft FVM statement.

(c) "Transaction costs" are defined by IAS 39 (Par.9) as "the incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument." IAS 39 (AG13) further explains that transaction costs include fees and commissions paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and securities exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs.

(d) "Point-of-sale costs" as defined by IAS 41 (Par.14) "include commissions to brokers and dealers, levies by regulatory agencies and commodity exchanges, and transfer taxes and duties, exclude transport and other costs necessary to get assets to a market".

10 The Staff observes that transaction type costs are consistently discussed separate from fair value. As such, the Staff concludes fair value measures in IFRS consistently exclude transaction type costs unless separately included by a standard. This conclusion is supported, for example, by paragraph AG67 of IAS 39, which illustrates a financial instrument recorded at fair value on subsequent measurement is valued without consideration of the transaction costs that would be incurred if the instrument were to be sold. *Please note – this paper does not discuss instances where the transaction price includes transaction costs, thus differing from a fair value measurement on initial recognition. That issue is discussed in Agenda Paper 8D.*

11 IFRS contains limited information on transportation costs. Paragraph 9 of IAS 41 states:

> "The fair value of an asset is based on its present location and condition. As a result, for example, the fair value of cattle at a farm is the price for the cattle in the relevant market less the transport and other costs of getting the cattle to that market"

12 However, beyond this brief discussion in IAS 41, it is not clear in IFRS if transportation costs should be included in the fair value measurement or if such costs should be considered "costs of disposal" or "transaction costs".

DEFINITIONS AND TREATMENTS IN THE CANANDIAN PAPER

13 The Canadian paper treats transaction and transportation costs similarly to the draft FVM statement. The Canadian paper considers costs in terms of "value affecting properties". An incremental cost to acquire, issue or dispose an asset or liability that is not recoverable in the market (ie, it is not value affecting) should be excluded from the fair value measure. Alternatively, if an incremental cost has been incurred that affects the value of the asset or liability such that a market would be willing to pay for the cost; the cost should be included in the fair value measurement.

14 Paragraph 194 of the Canadian paper provides an example to illustrate this concept:

> "As an example, suppose that a particular commodity must be imported and attracts an import duty that is paid by the importer. The duty is not a transaction cost as defined above if the importer could recover it in reselling the commodity in the domestic market because buyers in the domestic market would have had to pay the duty themselves if they had imported the commodity. It is not necessary that the importer intend to resell the commodity, because the market value of an asset or liability on initial recognition is unaffected by an entity's marketing intentions. *[footnote 69 continues – It is possible that a cost may be recoverable only in part in the marketplace, in which case only the portion that is not recoverable would be considered to be a transaction cost.]*"

15 Additionally, the Canadian paper proposes that transaction and other costs that an entity may have to pay in order to realize the fair value of an asset or to settle the fair value of the liability may meet the definition of a liability. In such cases, the Canadian paper proposes these costs be recognized separately or expensed if these costs are not recoverable in the marketplace. In either case, the costs are not included in the fair value of the asset or liability.

16 Finally, the Canadian paper concludes that costs that are considered necessary to complete an asset should be distinguished from transaction costs. The fair value objective in the Canadian paper is to measure the fair value of an incomplete asset in its place and condition at the measurement date. The Canadian paper proposes an

appropriate estimate of the fair value of an incomplete asset might be made by deducting the discount that the market would require for the asset's lack of completeness from the observable fair value of an otherwise equivalent complete asset.

STAFF ANALYSIS AND RECOMMENDATION

Transaction Costs

17 The definitions of transaction type costs vary in IFRS, though such costs are consistently excluded from fair value measurements. Further the Staff concludes IFRS is not currently clear (with the exception of IAS 41) whether transportation costs are an attribute of the asset or liability, and as such should be included in the fair value measurement.

18 The Staff observes transaction costs can be either explicit or implicit. Explicit transaction costs are separate from the price a market participant (seller) would receive to sell an asset or pay to transfer a liability. Explicit costs include items such as sales commissions, legal fees, and brokerage fees. Both the draft FVM statement and current IFRS exclude these types of costs from a fair value measurement because they are an attribute of the transaction, not an attribute of the asset. The Staff agrees with this characterisation.

19 In comparison, implicit transaction costs are those that are not separately identifiable or separable from the price a market participant (seller) receives for an asset or pays to transfer a liability. For example, implicit transaction costs are likely a component of the bid-asked spread. In fact, paragraph AG70 of IAS 39 currently states IAS 39 uses the term 'the bid-ask spread' to include only transaction costs. While the Staff does not agree transaction costs are the only thing that cause bid-ask spreads in observable markets, the Staff accepts transaction costs are a component of the spread.

20 Implicit transaction costs are not currently discussed in IFRS, other than in the context of bid-asked spreads. IFRS currently requires assets to be recorded at the bid price and liabilities at the asked price in circumstances where bid asked spreads are present. Some might observe that by measuring an asset at the bid price and a liability to at the asked price, the fair value measure actually includes transaction costs and that this

seems contrary to how IFRS treats explicit transaction costs when measuring fair value. However, other might say that the implicit transaction costs is actually a component of the initial transaction, which was at or near the ask price for an asset and the bid price for a liability. Thus, for an asset acquired at the ask price, measuring fair value at the bid price results in recognition of the transaction costs contained within the bid-asked spread which is consistent with treatment of other fair value measures. The Staff refers to the discussion and recommendation in Agenda Paper 8E which recommends the principle that a fair value measurement should be at the point within the bid-asked spread where an entity expects to transact.

21 Transaction type costs can be either costs previously incurred by an entity incurred in brining the asset or liability into its current location and condition, or they can be prospective costs that an entity would incur if they were to sell an asset or transfer a liability at the measurement date.

(a) Transaction costs that were previously incurred in bringing an asset or liability into its current condition become attributes of the asset or liability that is being valued. These costs could include:

(i) Duties or taxes paid when importing an asset,

(ii) Brokerage or market fees incurred in executing or structuring a structured financial instrument.

The Staff reasons these costs are no different than labour costs incurred when transforming raw materials to finished product. These costs might affect the value of the asset or liability and may result in a higher or lower fair value. However, a fair value measurement is not the same as historical cost accumulation. Just because an entity incurred a historical transaction cost does not mean the cost becomes a component of the fair value measurement. Finally, such historical transaction costs are not the type of transaction costs discussed in paragraph 10 of the draft FVM statement.

(b) Prospective transaction costs are the costs that would be incurred if an asset or liability were to be sold or transferred at the measurement date. By definition, prospective transaction costs are costs that have not yet been incurred. The Staff considered these costs to be the types of costs that should be excluded from a fair value measurement in accordance with paragraph 10 of the draft FVM statement.

Transportation costs

22 Regarding transportation costs, the Staff reasons that the value of an asset or liability is affected by the location of the asset or liability in relation to the principle market in which it would be sold. The following example illustrates this view:

(a) Consider a comparison of two sheep. The sheep are identical in all aspects except their location. One sheep is located on a farm directly adjacent to principle market. The second sheep is located in a remote mountainous area 200 miles from the same principle market. Neither owner of the sheep has immediate plans to sell the sheep on the measurement date.

(b) On the measurement date, sheep are selling the principle market for CU 100. The owner of the first sheep would not incur any cost to bring the sheep to market. However, the owner of the second sheep would incur costs of CU10 to transport the sheep to market. Both owners would be required to pay a commission of CU 5 to the market agent in order to sell the sheep. What are the fair values of the sheep on the measurement date?

(c) The Staff concludes the fair value of the first sheep is CU 100. In comparison, the fair value of the second sheep is CU 90. The difference in value between the first sheep and the second is due to the location. The second sheep has diminished value in comparison to the first sheep because of its remote location. The cost to transport the sheep to the principle market is a way to measure the reduction of value.

(d) The transaction cost of CU 5 is not included in the fair value of either sheep because the Staff reasons the transaction cost is an attribute of the decision to sell, not an attribute of the asset. Such costs would only be recorded if specifically required by a standard and would be separate from the fair value measurement.

23 This reinforces the concept that a fair value measurement for a particular asset or liability should consider the factors specific to that asset or liability, including its

condition and location. However, the concept of is broader than transportation costs. The Staff reasons factors specific to an asset or liability include:

(a) The location of the asset or liability;

(b) Contractual or legal restrictions attached to the asset or liability;

(c) The condition of the asset or liability (economic depreciation).

24 These factors are different from transaction costs. Transaction costs will differ depending on how an entity structures a transaction. How an entity structures a transaction does not change the value of the asset or liability. A change in the factors discussed above result in a physical change to the location or attributes of the asset the asset or liability. Changes in these factors therefore change the value of the asset or liability.

Staff Recommendation

25 The Staff agrees with the conclusions in the draft FVM statement regarding transportation and transaction costs. However, the Staff concludes the discussion of what types of costs are attributes of the asset or liability could be more robust as it is difficult to decipher justification for different treatment of transaction costs and transportation costs in the current discussion in the draft FVM statement. As such, the Staff recommends the invitation to comment include a question on the sufficiency of the discussion of costs that are attributes of an asset or liability, such as transportation costs. A proposed draft of the question in the invitation to comment follows:

Question X – Discussion of value-affecting properties

The Draft IFRS indicates a fair value measurement considers the current condition and location of an asset or liability at the measurement date. Further, the draft IFRS states in situations in which the location of an asset or liability is an attribute of the asset or liability, the fair value measurement shall include transportation costs. The Board agrees with these conclusions. However, the Board believes additional guidance on the various types of value-affecting properties, including location of the asset or liability, would be useful. Such guidance would elaborate on matters such as:

(i) when location is and is not an attribute of an asset or liability

(ii) other types of value-affecting properties, such as legal or contractual rights attached to an asset or liability

(iii) economic depreciation leading to decreased utility of a non-financial asset

Do you think the draft IFRS sufficiently discusses value-affecting properties? If not, what additional guidance would be useful and why?

26 Does the Board agree with the Staff recommendation?