STAFF PAPER

January 2017

IASB Meeting

Project	**Conceptual Framework**		
Paper topic	Factors specific to initial measurement		
CONTACT(S)	Andrew Lennard	alennard@ifrs.org	+44 (0) 20 7246 6930
	Rachel Knubley	rknubley@ifrs.org	+44 (0) 20 7246 6904

Purpose of paper

1. This paper:
   (a) provides a summary of the comments received on the proposals in the Exposure Draft *Conceptual Framework for Financial Reporting* (the Exposure Draft) about factors specific to initial measurement; and
   (b) makes recommendations for the revised *Conceptual Framework for Financial Reporting* (revised *Conceptual Framework*)
2. This paper is structured as follows:
   (a) summary of staff recommendations (paragraph 5);
   (b) exchanges of items of similar value and exchanges of items of different values (paragraphs 6–13);
   (c) transactions with holders of equity claims (paragraphs 14–20);
   (d) internally constructed assets (paragraphs 21–26).
3. Agenda Paper 10C provides, in marked-up form, an illustration of how the staff recommendations might be reflected in redrafting the revised *Conceptual Framework.* The Board is not asked to approve this illustrative draft. An Appendix to this paper

sets out other comments received on initial measurement and the staff's proposed responses.

4. Questions for the Board are set out after paragraphs 13, 20 and 26.

Summary of staff recommendations

5. We recommend that the revised *Conceptual Framework*:

   (a) retains the main principles about initial measurement set out in the Exposure Draft;

   (b) distinguishes transactions that are on arm's length terms from other transactions, rather than referring to 'exchanges of items of similar value' and 'exchanges of items of different values';

   (c) consistently with the Exposure Draft, states that a transaction with holders of equity claims is measured at the current value of the asset received with a corresponding contribution from owners;

   (d) expands the principle covering transactions with holders of equity claims to address liabilities for distributions to holders of equity claims;

   (e) makes clear that the principle about transactions with holders of equity claims applies only to transactions on arm's length terms, and not addresses transactions on other terms; and

   (f) omits the discussion of internally constructed assets set out in the Exposure Draft.

Exchanges of items of similar value and exchanges of items of different values (Exposure Draft paragraphs 6.66–6.68; 6.70–6.71)

Exposure Draft proposals

6. In summary, the Exposure Draft:

   (a) in respect of exchanges of items of similar value stated that:

- (i) when an asset is acquired in exchange for incurring a liability, the asset and liability are normally initially measured at the same amount, and thus no income or expenses are recognised, except when transaction costs are not included in the initial measure of the asset or liability (paragraph 6.66(a)).
- (ii) when an asset is acquired, or a liability incurred, in exchange for transferring another asset or liability, the initial measure of the asset acquired (or the liability incurred) determines whether any income or expenses arise on the transfer (paragraph 6.66(b)).
- (iii) at initial recognition, cost is normally similar to fair value at that date, unless transaction costs are material. It also noted that, nevertheless, it is necessary to describe the measurement basis used at initial recognition, and that it would normally be appropriate to use the same measurement basis for initial measurement as that which will be used subsequently (paragraph 6.67).
- (iv) in some cases, the initial measure of one of the items exchanged may need to be used as the deemed cost of the other item (paragraph 6.68).

(b) in respect of exchanges of items of different values:

- (i) described circumstances where two items of different values are exchanged, and stated that in these cases measuring the asset acquired or the liability incurred at historical cost may not faithfully represent income or expenses (for example, a loss arising from overpayment or a gain arising from a bargain purchase) (paragraph 6.70).
- (ii) stated that where an asset is acquired, or a liability is incurred for no consideration, historical cost of zero would be unlikely to provide a faithful representation of the assets and liabilities of the entity, and that it may be appropriate to measure such assets and liabilities at a current value and recognise the difference as income or expense (paragraph 6.71).

Feedback from respondents

7. Respondents offered no comments specifically on the proposals set out in the Exposure Draft on exchanges of items of similar value.

8. The few respondents who commented on the approach set out in the Exposure Draft to initial measurement of exchanges of items of different values expressed reservations.

9. The Canadian Accounting Standards Board (AcSB) recommended that paragraphs 6.69[1] to 6.71 (summarised at paragraph 6(b) above) be removed. These paragraphs are troubling, AcSB said, because they are inadvertently establishing a principle that transactions with related parties should be measured at current value. These paragraphs, the AcSB said, are underdeveloped and incomplete: for example, the paragraphs do not discuss whether the same treatment should apply to both an arm's length transaction and a related-party transaction. In the AcSB's view, the revised *Conceptual Framework* should clearly state that the underlying assumption is that the measurement concepts apply to transactions conducted between arm's length parties.

10. Norsk RegnskapsStiftlese (the Norwegian Accounting Standards Board) questioned whether the section that addressed 'factors specific to initial measurement' should be retained in the revised *Conceptual Framework*, or whether issues would be more appropriately addressed in the development of Standards.

11. Deloitte said the measurement chapter is missing an important assumption—that transactions between entities are fair exchanges (ie they are orderly or negotiated transactions). The chapter should then go on to discuss the implications of relaxing that assumption—for example where exchanges are non-reciprocal, under duress or between related parties.

[1] Paragraph 6.69 of the Exposure Draft addressed transactions with holders of equity claims. Because some correspondents restricted their reservations to this paragraph, it is discussed separately at paragraphs 14–20 below.

Staff analysis and recommendation

12. The staff suggest that it is useful for the revised *Conceptual Framework* to address measurement at initial recognition, and, in particular, to set out when an asset received, or a liability incurred, should be measured initially at the transaction price, and when it may be appropriate to use a current value. However, the discussion in the Exposure Draft may be improved, by clarifying which of its paragraphs are intended to apply in which circumstances.

13. The Exposure Draft contrasted 'exchanges of items of similar value' and 'exchanges of items of different values'. These terms are problematic. 'Similar' is vague. More fundamentally, apart from trades on deep and liquid markets, arm's length transactions do not provide evidence of similar values: rather, they provide evidence that each party attaches a value that is at least as great to the item received than to the item they transfer. For example, it is reasonable to assume that a customer attaches greater value to the asset purchased than to the cash paid or liability incurred, and that the seller attaches less value to the asset it sells than to the cash or debtor received. The staff therefore recommend that the language about 'exchanges of items of similar/different values' is replaced by referring to 'transactions that are or are not on arm's length terms'.

Question 1

The staff recommend that:

(a) The revised *Conceptual Framework* should retain the main principles about initial measurement that were set out in the Exposure Draft and summarised at paragraph 6 above.

(b) Rather than refer to 'exchanges of items of similar value' and 'exchanges of items of different values', the revised *Conceptual Framework* should distinguish between transactions that are on arm's length terms from other transactions.

Do you agree?

Transactions with holders of equity claims

Exposure Draft proposals

14. The Exposure Draft stated that where an entity receives an asset from a holder of an equity claim it would normally be appropriate to measure the asset at a current value and to recognise a contribution from the holder of the equity claim. If the asset is subsequently measured at historical cost, the current value at the time of receipt would form the deemed cost of the asset (paragraph 6.69).

Feedback from respondents

15. A few respondents disagreed with this proposal. Points made by these respondents were as follows.

    (a) An accounting professional body noted that where equity is issued in an intra-group transaction, the issue is commonly recorded at the historical book value of the asset received. An accounting firm made the same point and said that it should be clear that the principle does not extend to non-arm's length terms transactions.

    (b) Another accounting firm was concerned not only about intra-group transactions but also about business combinations under common control. It also noted that the principle would imply grossing up underpayments, and was concerned about the time and cost that would be required to obtain valuations.

    (c) A standard-setter expressed the view that the measurement basis used should be based on which item (the asset or the equity) has a more reliable measurement.

16. One accounting firm supported the principle in paragraph 6.69, and offered a suggested revised version that would expand its scope to include all transactions with holders of equity claims, including those where a distribution is made and a liability is recognised.

Staff analysis and recommendation

17. The principle that arm's length transactions with holders of equity claims should be measured at current value is sound, because a current value is necessary to provide a faithful representation of the asset received and the amount of the contribution from holders of equity claims. In the staff's view the revised *Conceptual Framework* should make this clear.

18. Some may consider that where the value of the asset received is lower than the value of the equity rights issued, the contribution from holders of equity claims should be recognised at the value of the rights issued, and an expense recognised for the difference between that amount and the value of the consideration received. The expense would represent either an overpayment for the asset received or unidentified assets or services received. This seems to be implicit in IFRS 2 *Share-based Payment*, which states: 'In the absence of specifically identifiable goods or services, other circumstances may indicate that goods or services have been (or will be received) in which case this IFRS applies' (paragraph 2). The Basis for Conclusions accompanying IFRS 2 states that 'When the Board developed IFRS 2, it concluded that the directors of an entity would expect to receive some goods or services for the equity instruments issued (…).' (paragraph BC18C).

19. The concept spelled out in paragraph 18 has merit, but would go beyond the proposals set out in the Exposure Draft, and would not be responsive to comments received. It would also pre-empt the Board's consideration of business combinations under common control. The staff therefore recommend that the revised *Conceptual Framework* address only transactions on arm's length terms with holders of equity claims.

20. The Exposure Draft confined its discussion of transactions with holders of equity claims to the case where an asset is received and a contribution is recognised. Extending the principle to include the case where an entity incurs a liability to make a distribution to holders of equity claims would make the revised *Conceptual Framework* more complete, and would seem uncontroversial. The staff therefore recommend that the paragraph be revised to address distributions.

Question 2

We recommend that the revised *Conceptual Framework* should:

(a) state that a transaction with holders of equity is measured at the current value of the asset received with a corresponding contribution from owners (as reflected in the Exposure Draft);

(b) expand the principle to address liabilities incurred to make distributions to holders of equity in their capacity as such;

(c) make clear that this principle applies only to transactions on arm's length terms; and

(d) only address transactions with holders of equity that are on arm's length terms.

Do you agree?

Internally constructed assets (Exposure Draft paragraphs 6.72–6.73)

Exposure Draft proposals

21. The Exposure Draft stated that:

    (a) where assets are constructed by an entity, unnecessary changes in measurement bases can be avoided by using the same basis for initial measurement as that which would be used subsequently (paragraph 6.72); and

    (b) measuring the asset on its completion date at a fair value would provide relevant information about the cost-effectiveness of construction by recognising income or expense, but may not be cost-effective for unique or custom-made assets (paragraph 6.73).

Feedback from respondents

22. A few respondents disagreed with these paragraphs because:

    (a) the suggestion that financial statements should provide information on cost-effectiveness should be reconsidered, as it could have wider implications, for example, for inventory;

    (b) the information provided by measuring an internally constructed asset at fair value is not useful for assessing cost-effectiveness, as an entity does not make money by transacting with itself;

    (c) as noted in the Exposure Draft, it may be difficult to determine fair value in some cases; and

    (d) the paragraphs are unnecessary.

Staff analysis and recommendation

23. The point that it is desirable for a measurement basis used for initial measurement to be consistent with that to be used for subsequent measurement is made elsewhere in the Exposure Draft (paragraph 6.52).[2] The staff propose no substantive change to this paragraph. Thus paragraph 6.72 is redundant.

24. The content of paragraph 6.73 is limited to setting out one consideration that might justify a change in a measurement basis from historical cost to fair value, and noting one consideration against it. This is hardly a comprehensive discussion of the issue, which would seem more appropriately addressed in the development of IFRS Standards.

25. Investment property that will subsequently be accounted for under the fair value model is one case where an internally constructed asset might be appropriately reported at fair value. IAS 40 *Investment Property* permits fair value to be used for investment property in such a case (although it allows fair value for property in the

[2] Comments received about this paragraph and staff responses to these comments are given in the Appendix.

course of construction, if it is reliably measurable, and not only on completion, as stated in paragraph 6.73 of the Exposure Draft).

26. Retaining paragraph 6.73 might lead to a misunderstanding of the Board's intention for Standards dealing with internally constructed assets, such as factories and warehouses that will be used together with other resources to provide goods and services to customers. The Board has tentatively decided that the revised *Conceptual Framework* will state that a cost-based measure is likely to be relevant for such assets.

Question 3
We recommend that the revised *Conceptual Framework* should omit the discussion of internally constructed assets set out in the Exposure Draft. Do you agree?

Question 4
Do you wish to make any comment on: (a) the matters noted in the Appendix? (b) the illustrative draft set out in Agenda Paper 10C?

Appendix—Other comments on initial measurement

This Appendix sets out other comments received on initial measurement and the staff's proposed responses.

	Respondents' comments	Staff's responses
A1	A few respondents question the statement in the Exposure Draft (at paragraph 6.52) that the measurement basis used for initial and subsequent measurement should be the same, and therefore cannot be considered separately. Examples given include assets and liabilities acquired in a business combination that are subsequently accounted for other than at fair value. One respondent thought that consistency may not be useful in all circumstances: another suggested that the subsequent accounting for an asset should not determine its initial measurement.	The staff consider that generally the measurement basis used for initial measurement should generally be the same as that used for subsequent measurement. If in any future Standard a different approach is necessary, this should be explained in the Basis for Conclusions. The staff therefore propose retaining the point in the revised *Conceptual Framework.*
A2	A few respondents noted that 'exchanges of items of similar value' does not cover provisions, for which there may be no exchange.	The staff will consider this in drafting.
A3	A few respondents questioned the assertion (Exposure Draft paragraph 6.67) that at initial recognition the cost of an asset is similar to its fair value, subject to transaction costs. They noted that bargain purchases and overpayments sometimes occur.	The staff will consider this in drafting.
A4	A few respondents noted that the revised *Conceptual Framework* should permit the initial measurement of an asset to be at the fair value of the asset given in exchange.	This seems to be consistent with the intent of the Exposure Draft. The staff will consider this in drafting.

	Respondents' comments	Staff's responses
A5	One respondent questioned whether a grant received subject to conditions would require a liability to be recognised.	If the conditions give rise to a liability, this would be consistent with the principles set out in the revised *Conceptual Framework*. A specific reference seems to be unnecessary detail.