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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board meeting: **22 June 2006, London**

Project: **Fair Value Measurements**

Subject: **Day-one Gains and Losses (Agenda Paper 9A)**

Introduction and purpose of this paper

1 Fair value, as defined in the FASB's draft FVM statement and as tentatively approved by the Board, is an exit price. As discussed at the May 2006 Board meeting, an exit price is conceptually different from a transaction price paid to acquire an asset or received to assume a liability (an entry price). As a result of the Board's tentative approval of the exit price definition of fair value, in circumstances where an asset or liability is required to be measured at fair value on initial recognition a day-one gain or loss may be identified.

2 In this paper, the Staff concludes the existing guidance on in IAS 39 *Financial Instruments: Recognition and Measurement* on the recognition of so-called 'day-one gains and losses' for financial assets and liabilities is inconsistent with the exit price notion of fair value that has been tentatively approved by the Board. The Staff believes the guidance on day-one gains and losses requires amendment.

3 This paper therefore asks the Board whether the FVM project should:

a. Consider only consequential amendments to IAS 39 that are required in order to conform with the guidance in the FVM statement, and to leave the current accounting guidance on the recognition of day-one gains and losses in IAS 39 unchanged; or

b. Make not only consequential amendments to IAS 39, but also to possibly amend the current guidance on the recognition of day-one gains and losses in IAS 39.

Existing IFRS guidance on day-one gains and losses

4 Guidance on day-one gains and losses in IFRS is limited to IAS 39 and is discussed in conjunction with the presumption that in most situations the transaction price provides the best evidence of fair value on initial recognition. Following are excerpts from the guidance in IAS 39:

a. Paragraph AG64: "The fair value of a financial instrument on initial recognition is normally the transaction price (ie the fair value of the consideration given or received, see also paragraph AG76). However, if part of the consideration given or received is for something other than the financial instrument, the fair value of the financial instrument is estimated, using a valuation technique (see paragraphs AG74-AG79).

b. Paragraph AG76: "The best evidence of the fair value of a financial instrument at initial recognition is the transaction price (ie the fair value of the consideration given or received) unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (ie without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets."

c. AG76A states: "The subsequent measurement of the financial asset or financial liability and the subsequent recognition of gains and losses shall be consistent with the requirements of this Standard. The application of paragraph AG76 may result in no gain or loss being recognised on the initial recognition of a financial asset or financial liability. In such a case, IAS 39 requires that a gain or loss shall be recognised after initial recognition only to the extent that it arises from a change in a factor (including time) that market participants would consider in setting a price."

d. The Basis of conclusions to IAS 39 elaborates on this guidance in paragraphs BC104 and BC222(v)(ii):

    i. BC104: "The Board also considered constituents’ comments regarding whether an instrument should always be recognised on initial recognition at the transaction price or whether gains or losses may be recognised on initial recognition when an entity uses a valuation technique to estimate fair value. The Board concluded that an entity may recognise a gain or loss at inception only if fair value is evidenced by comparison with other observable current market transactions in the same instrument (ie without modification or repackaging) or is based on a valuation technique incorporating only observable market data. The Board concluded that those conditions were necessary and sufficient to provide reasonable assurance that fair value was other than the transaction price for the purpose of recognising up-front gains or losses. The Board decided that in other cases, the transaction price gave the best evidence of fair value. The Board also noted that its decision achieved convergence with US GAAP."

ii. BC222(v)(ii): "Some constituents asked the Board to clarify that straight-line amortisation is an appropriate method of recognising the difference between a transaction price (used as fair value in accordance with paragraph AG76) and a valuation made at the time of the transaction that was not based solely on data from observable markets. The Board decided not to do this. It concluded that although straight-line amortisation may be an appropriate method in some cases, it will not be appropriate in others."

5 As noted above, the Board has previously tentatively agreed with the Staff recommendation that the transaction price may differ from fair value on initial recognition. Therefore, the Staff plans to amend the transaction price guidance in paragraphs AG64 and AG76 accordingly. However, the Staff has not previously discussed with the Board the guidance on accounting for circumstances where the transaction price and the fair value measurement are different on initial recognition.

Staff analysis

6 As discussed previously, the Staff believes an exit price objective of fair value more clearly conveys a single measurement objective that is generally consistent with the existing measurement objectives of fair value in IFRS, particularly for subsequent measurements or remeasurements at fair value *(note - the Staff plans to confirm with the Board the scope decisions tentatively made nearer completion of deliberations of the final FVM statement and prior to issuance of the exposure draft)*.

7 Specifically, the exit price notion of fair value is consistent with fair value measurement guidance in IAS 39. For example, paragraph AG71 states "The objective of determining fair value for a financial instrument that is traded in an active market is to arrive at the price at which a transaction would occur at the balance sheet date in that instrument (without modifying or repackaging the instrument) <u>*in the most advantageous market*</u> to which the entity has immediate access [emphasis added]." The fact that an entity is supposed to look to the most advantageous market infers they should look to the market that would maximise the price they would receive for the instrument. This is an exit price notion.

8 Therefore, if subsequent measurement of a financial instrument is meant to be an exit price, the Staff believes a fair value measurement on initial recognition should also be an exit price in order to have a consistent measurement objective. Day-one gains and losses for any difference between the transaction price and the exit price notion of fair value are a direct consequence of such a conclusion.

9 The Staff notes that concerns regarding the recognition of day-one gains are not necessarily due to a disagreement with the exit price objective of fair value. Rather, most concerns appear to be related to broader issues relating to the recognition of gains (and to a lesser extent, losses) in situations where the components of fair value measurement cannot be directly observed in a market. However, the Staff views such concerns more as a reliability of measurement issue rather than a concern with an exit price notion of fair value.

10 In order to have a consistent measurement objective, the Staff believes it may be more appropriate to separate the exit price fair value measurement from the

unrecognized day-one gain or loss. This view is based on the following reasons:

a. IAS 39 currently requires all financial assets and liabilities to be measured at fair value on initial recognition and many financial instruments to be measured at fair value on subsequent remeasurement (including all derivative instruments[1] and available-for-sale securities). The requirement to measure such instruments at fair value applies regardless of whether the fair value inputs are observable or unobservable in a market.

b. However, existing guidance on day-one gains and losses adds an exception for financial instruments whose fair value measurement is not entirely based on observable market inputs. The existing guidance on day-one gains and losses forces the initial measurement to be at the transaction price, even if this is not consistent with the reporting entitiy's fair value measurement for the financial asset or liability. In contrast, subsequent changes in the fair value are expected to be recognized, even though these subsequent movements will be based on the same unobservable inputs that were not sufficient for initial recognition.

c. Furthermore, guidance on how the reporting entity should account for identified day-one gains or losses in subsequent periods IAS 39 has led to significant diversity in practice. The Staff understands that most entities with day-one gains generally recognize the deferred day-one gain systematically into income over the life of the instrument. However, some entities defer the day-one gain in its entirety until such time as the fair value measurement is observable or until the position is closed. Both of these approaches have their drawbacks:

    i. Amortization approach - Amortizing the identified day-one gain systematically into income over the life of the financial

[1] With the exception of derivatives that are linked to and must be settled by delivery of investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured. Such instruments shall be accounted for at cost, in accordance with paragraph 46(c) of IAS 39.

instrument results in a subsequent measurement that is neither a current entry price nor a current exit price.

ii. Deferral approach - Deferring the entire day-one gain until it is observable while recognizing underlying changes in the fair value of the financial instrument may result in measurement that is more akin to a current entry price that an exit price notion of fair value. As a result, the fair value measurement for financial assets and liabilities differs depending on whether the inputs to the fair value measurement are observable or unobservable.

11 For these reasons, the Staff believes existing guidance on day-one gains is inconsistent with the fair value measurement objective in the draft FVM statement. Therefore, the Staff proposes this guidance be amended either in the FVM project or contemporaneously with the FVM project in a separate amendment to IAS 39. To clarify, the Staff recommends considering not just the guidance on day-one gains, but also whether such gains or losses should be realized. However, even if the Board were to conclude that a day one-gain or loss should be deferred given the unobservable nature of the inputs to the fair value measurement, the Staff believes the existing guidance should be modified to separate the deferred amount from the fair value measurement in order to keep the fair value measurement objective consistent for all financial assets and liabilities.

12 If the Board agrees this issue needs to be considered in conjunction with the FVM project, the Staff plans to continue discussions with preparers and users in order to develop a Staff recommendation as quickly as possible (the Staff would aim to bring this recommendation to the Board in the July Board meeting).

13 If the Board does not wish to address the issue of day-one gains and losses at this time, the Staff will work to bring a draft consequential amendment to IAS 39 that will keep the existing accounting for day-one gains and losses while modifying the fair value measurement guidance to be consistent with the draft FVM statement. Again, the Staff would aim to bring a draft of this consequential amendment to the Board in July.

Questions to the Board

14 Does the Board wish to consider amending the guidance on so-called day-one gains in IAS 39? If so, does the Board want to do this as a consequential amendment to IAS 39 within the FVM project?

15 Additionally, while the Staff is not requesting any decisions by the Board regarding whether day-one gains and losses should be recognized, the Staff would appreciate hearing any preliminary thoughts on this issue.