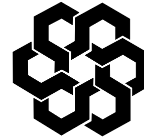

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**International Accounting Standards Board**

*This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.*
*These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.*

**INFORMATION FOR OBSERVERS**

**Board Meeting:** **December 2008, London**

**Project:** **Fair Value Measurement**

**Subject:** **Day one gains or losses: Practical application (Agenda paper 3D)**

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## Introduction

1 At its November 2008 meeting, the Board discussed whether it is appropriate to recognise a gain or loss when IFRSs require or permit fair value at initial recognition. Board members may wish to refer to agenda Paper 17A from that meeting.

2 Agenda Paper 17A for November contained three potential approaches:

a **Approach 1:** Prohibit day one gains or losses in all circumstances.

b **Approach 2:** Require day one gains or losses in some circumstances, such as when the initial fair value measurement is based entirely on observable market inputs (the current approach in IAS 39 *Financial Instruments: Recognition and Measurement*).

c **Approach 3:** Require day one gains or losses even when the initial fair value measurement is derived using unobservable inputs (the approach in FASB Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157)).

3 At that meeting, the Board asked the staff to research how entities obtain and evaluate evidence to support a conclusion that a fair value measurement at initial recognition is different from the transaction price if that fair value measurement is derived using unobservable inputs.

4 The staff solicited feedback from some of the financial institutions applying SFAS 157, specifically asking how they apply paragraph 17 of SFAS 157. Paragraph 17 states: [1]

> In many cases, the transaction price will equal the exit price and, therefore, represent the fair value of the asset or liability at initial recognition. In determining whether a transaction price represents the fair value of the asset or liability at initial recognition, the reporting entity shall consider factors specific to the transaction and the asset or liability. For example, **a transaction price might not represent the fair value of an asset or liability at initial recognition if:**
>
> (a) **The transaction is between related parties**.
>
> (b) **The transaction occurs under duress or the seller is forced to accept the price in the transaction**. For example, that might be the case if the seller is experiencing financial difficulty.
>
> (c) **The unit of account represented by the transaction price is different from the unit of account for the asset or liability measured at fair value**. For example, that might be the case if the asset or liability measured at fair value is only one of the elements in the transaction, the transaction includes unstated rights and privileges that should be separately measured, or the transaction price includes transaction costs.
>
> (d) **The market in which the transaction occurs is different from the market in which the reporting entity would sell the asset or transfer the liability**, that is, the principal or most advantageous market. For example, those markets might be different if the reporting entity is a securities dealer that transacts in different markets, depending on whether the counterparty is a retail customer (retail market) or another securities dealer (inter-dealer market). [emphasis added]

5 This paper summarises that feedback and asks the Board whether, and if so in what circumstances, to require the recognition of a gain or loss for assets and liabilities that are measured at fair value at initial recognition.

[1] In the July 2008 IASB meeting (see Agenda Paper 11A for that meeting), the staff asserted that the only difference could be (d), that is when the entry market differs from the exit market. The staff noted that (a) and (b) do not represent fair value and that (c) represents a different asset or liability (or form thereof) being measured.

### Practical application of SFAS 157 when recognising day one profits or losses

6 The financial institutions interviewed said that the most important criterion for recognising a day one gains or loss is that they must have reason to believe that they will be able to realise that profit (or loss).[2] In other words, they did not see the nullification of footnote 3 of EITF 02-3 as a 'free for all'. This was also clarified in a speech given by a US Securities and Exchange Commission staff member shortly after SFAS 157 was published.[3]

7 The staff obtained feedback on the following matters related to the practical application of SFAS 157:

a factors that cause a fair value measurement at inception to differ from the entity's transaction price: there must be a rationale for recognising profit at inception that is founded upon those factors;

b evidence required to support using an amount different from the transaction price at inception: if there is a justifiable rationale for recognising a profit, the model used must be robust and the inputs must be verifiable;

c control processes for the recognition of day one gains or losses: there are several layers of review by senior personnel and significant transactions must be approved before profit can be recognised;

d the entity's policies and processes for subsequently recognising deferred amounts (ie 'releasing' the deferred profit): the threshold for recognition is the same on day one and day two;

e the effect of transitioning from Emerging Issues Task Force Issue No. 02-3 *Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities* (EITF 02-3) to SFAS 157: SFAS 157 allows entities to use judgement

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[2] Although this paper addresses both gains and losses, most of the conversations centred around gains. During the discussions, the staff asked some of the financial institutions how often they recognise day one losses. Most responded that it was not often, mainly because they do not voluntarily enter into transactions that are not profitable. However, they also acknowledged that they might do so in order to obtain an important client or to enter into a new line of business they think will become profitable over time.

[3] Speech by the SEC Staff: Remarks before the 2006 AICPA National Conference on Current SEC and PCAOB Developments, by Joseph D. McGrath. 11 December 2006.

about what they think the exit price would be. The control processes and model validation procedures put in place for applying EITF 02-3 are helpful for applying SFAS 157 so that it has not become a ‘free for all’; and

f potential additional disclosure requirements if the Board decides to pursue Approach 3 (the SFAS 157 approach): the Level 3 roll-forward in SFAS 157 provides transparency. Additional disclosures about control processes and risk exposures might also be useful.

8 The feedback received for each of these matters is summarised below.

***Factors Causing Fair Value at Inception to Differ from the Transaction Price***

9 All of the financial institutions said that there needs to be a justifiable rationale for recognising a profit at inception. They cited the following factors as contributing to day one differences, many of which are interrelated:

a transaction to sell is expected to occur in a different market than the transaction to buy (eg retail/wholesale spread).

b transaction to sell is expected to occur at a different point within the bid/ask spread than the transaction to buy.

c arbitrage opportunities.

d structuring fees embedded in the transaction price that are not reflected in the fair value measurement of the asset or liability at inception. These structuring fees vary based on the size and complexity of the transaction.

e monetising differences in risk preferences. These entities are in the business of taking and managing risks and they seek to profit from differences in risk preferences. They do this by retaining (‘warehousing’) and/or hedging risk.

10 At a high level, most of the above factors relate to the financial institution’s ability to transact in difference markets.

11 The financial institutions we spoke with said that the presence of one or a few of the above factors alone is not conclusive evidence of a day one gain or loss, particularly when a fair value measurement is derived using significant unobservable inputs.

They told us that they must be able to gather enough evidence to determine whether any difference between the transaction price and fair value measurement at inception is attributable to a **realisable** gain or loss in order to support its recognition.

12 With regard to the observability criterion currently in IAS 39 (and that was in EITF 02-3), one financial institution noted that the observability of inputs does not change the profit rationale for a transaction. In other words, any one of the factors identified in paragraph 9 of this paper could lead to genuine economic gains whether or not those inputs are observable at inception.

***Evidence Required to Support Using an Amount Different from the Transaction Price at Inception***

13 The financial institutions we met with were unanimous in the view that 'substantive evidence' is needed to support a day one gain or loss when a fair value measurement is derived using unobservable inputs and that, in the absence of that evidence, the transaction price represents the best estimate of fair value at inception. In fact, some of them told us that they assume the transaction price represents fair value **unless** the trader can provide evidence to the contrary. They indicated that the burden of proof is placed upon each trader to support the day one 'mark' and that the trader must articulate the profit rationale for the transaction using all available information. That information might include:

a executable broker quotes;

b data from reputable pricing services;

c results from competitive auctions (both won and lost);

d valuation inputs derived from comparable market transactions;

e price verification obtained by offsetting a meaningful portion (eg the minimum size of an offsetting trade to ensure that the trade is meaningful to the market) of the entity's position in a current market transaction with a knowledgeable counterparty. They tend to discount model inputs obtained by reference to a transaction with an unsophisticated counterparty; and

f other empirical and 'compelling market-based evidence'.

14 Another important criterion is the suitability of the model used. One financial institution noted that the amount of evidence required to support a day one gain or loss increases when a transaction or model is relatively new or when the model includes significant unobservable inputs. In those circumstances, it is more likely that the transaction price will be deemed the fair value at inception.

15 All of the facts and circumstances of the transaction are considered and no single source of evidence is considered determinative when evaluating a fair value measurement derived using observable or unobservable inputs. Through the internal control processes, an independent valuation or risk management group uses judgement to determine whether the available evidence is substantive or persuasive enough to justify profit recognition. . An independent review is one of many control processes instituted by the financial institutions to ensure that the trader's mark meets the current exit price measurement objective.

***Control Processes for the Recognition of Day One Gains or Losses***

16 The financial institutions we spoke with cited numerous control processes for the recognition of day one gains or losses, including:

a transaction-by-transaction review of significant transactions, including documentation of profit rationale and supporting evidence;

b model and input validation, including reserving mechanisms to address liquidity risk, credit risk and market parameter and model uncertainty;

c extensive accounting and valuation policies; and

d centralised decision-making to ensure consistent application of the policies.

17 For many (if not all) of the financial institutions, the transaction-by-transaction review includes a formal sign-off for significant transactions by senior management and/or independent review functions that report to senior management. For at least one financial institution, significant transactions are submitted to a *global* peer review of senior management personnel to ensure that the entity is consistent in recognising day one gains or losses on a global basis. In each case, the objective is to arrive at their best estimate of the price that would be received in a hypothetical transaction at the

measurement date using assumptions that market participants would use in pricing the asset or liability.

18 Model validation includes an analysis of how the model works, how it will be used, who built the model, and the effectiveness of the model in replicating an exit price between market participants (eg backtesting). Although all models are evaluated on a regular basis, new models or existing models applied to new products undergo more scrutiny.

19 Input validation includes evaluating every significant input used in the model for observability and verifiability. One financial institution stated that they require all significant inputs to be verifiable in order to recognise a day one gain or loss.

20 To the extent that there is uncertainty about the application of the model and reasonably possible alternative assumptions for the underlying inputs, the financial institutions apply adjustments (typically called 'model valuation adjustments') to calibrate the model value to a current exit price. In doing so, they make their best estimate of the price that would be received in a hypothetical transaction at the measurement date using assumptions that market participants would use in pricing the asset or liability.

21 The financial institutions cited extensive accounting and valuation policies as another part of the control process governing the recognition of day one gains or losses. One financial institution's policy for recognising day one profits, for example, includes the following:

a effective date and scope of the policy,

b general approach for determining fair value, including a discussion of the hierarchy of inputs,

c evidence threshold, including minimum parameters that must be met (eg a minimum number of comparable trades of a particular size or a minimum number of executable broker quotes), and

d a decision tree of 'easy to follow' steps to help navigate the fair value measurement process.

### *Entity's Policies and Processes for Subsequently Recognising Deferred Amounts*

22 The control infrastructure described above is equally applicable to 'day two' fair value measurements. Each of the financial institutions said there are no differences in their control processes for day one measurements and day two measurements.

23 The financial institutions said they favour a consistent recognition threshold for initial and subsequent measurements (which is the approach in SFAS 157). They noted having a separate threshold for initial measurements (as with IAS 39, which allows for reasonable unobservable inputs for subsequent measurements but not for initial measurements) creates complexity in financial reporting. This is because entities must determine (and convey to users) when to recognise (in some cases, how to amortise) the deferred amounts appropriately.

24 They noted the following approaches for subsequently recognising deferred amounts:

a recognise the deferred amount based on the observability of inputs.

b amortise the deferred amount based on the passage of time.

c recognise the deferred amount when the underlying position matures or is sold.

25 Most of the financial institutions prefer to recognise deferred amounts based on the observability of inputs because they think it aligns the interests of the trader with those of the entity (ie the trader has little incentive to prove the validity of the underlying inputs when amortisation is based solely on the passage of time).

26 Even though most of the financial institutions prefer recognition based on observability, they noted that time-based amortisation might be appropriate in some circumstances. For example, some observable inputs might become unobservable over time and vice versa, making recognition based on observability less meaningful.

27 Some financial institutions do not favour recognising the deferred amounts upon exiting the underlying position because 'income is not earned when a position is closed out'. By this, they mean that the act of closing out a position does not create economic value or profit; rather, the act of closing out results in the realisation of the value that was created previously (ie due to the factors in paragraph 9).

28 Because we spoke with financial institutions, the focus was on financial instruments. The staff notes that the issue of when to recognise deferred amounts extends to non-financial assets and liabilities if the Board decides to pursue Approach 2 (the current IAS 39 approach). Under Approach 2, the Board will need to consider whether to require day one gains or losses for non-financial assets and liabilities and, if so, for which assets and liabilities and under what circumstances.

29 For example, the Board might need to reconsider its decision to require a gain in a business combination when there is a bargain purchase. The measurement of the consideration transferred and the net assets acquired often relies on significant unobservable inputs.

***The Effect of Transitioning from EITF 02-3 to SFAS 157***

30 SFAS 157 required that, for financial instruments initially recognised at the transaction price under EITF 02-3, entities recognise the difference between the carrying amounts and fair values of financial instruments as an adjustment to the opening retained earnings balance in the year SFAS 157 is adopted.

31 The financial institutions we spoke with said that, for their business, the transition from EITF 02-3 to SFAS 157 resulted in a modest amount of incremental earnings. This is because EITF 02-3 created market discipline for the recognition of day one gains or losses and that SFAS 157 is 'not a free for all'. They noted that, in order to recognise day one gains or losses under SFAS 157, entities must still support an exit price that is based on market participant assumptions.

32 Though the control processes largely remained unchanged during (and after) the transition, at least one financial institution mentioned that they felt they had to do more work in response to the transition to SFAS 157 from EITF 02-3. This is because SFAS 157 requires them to justify the parameters that are unobservable in addition to those that are observable. The strict requirements of footnote 3 of EITF 02-3, on the other hand, resulted in entities focusing only on measurements that had observable inputs. In other words, financial institutions applying SFAS 157 have had to add control processes documenting and justifying the recognition of a day one gain or loss when a fair value measurement is derived using unobservable inputs. This resulted in

increased discipline when measuring fair value, ensuring that the entity made all adjustments to calibrate the model value to a current exit price.

33 The staff analysed the incremental earnings effect of the transition from EITF 02-3 to SFAS 157 for nine leading financial institutions in the US. In that analysis, the staff calculated the EITF 02-3 earnings release into retained earnings as a percentage of profit from the preceding year. The staff's analysis shows that the transition from EITF 02-3 to SFAS 157 did not have a dramatic effect on reported earnings.

34 The results from that analysis are as follows:

| **EITF 02-3 Release as a % of Profit Before Release** | |
|---|---|
| Average Release | 0.909% |
| High Release | 1.988% |
| Low Release | 0.104% |

35 The above analysis should be interpreted with caution because:

a it assumes (for calculation purposes) that amount released pertains solely to deferred profits from the preceding year. This is unlikely to be case in every situation.

b any comparison of EITF 02-3 releases for financial institutions should be considered in the context of their respective portfolios.

36 Although the effect of the transition was not pronounced, several financial institutions noted that SFAS 157 gave them the flexibility to use judgement in their fair value measurements at inception. In their view, the strict observability criterion sometimes resulted in an artificial bright line for profit recognition.

37 For example, one financial institution we spoke with gave us an example of an option based on a basket comprising two oil indices that were highly correlated historically. However, the correlation was not observable at the measurement date. The lack of observability for a single significant input (correlation) led to the deferral of day one gains or losses even though the entity could demonstrate that the two indices have been and were expected to be highly correlated.

***Potential Additional Disclosure Requirements if the Board Decides to Pursue Approach 3***

38 The financial institutions believe that the Level 3 roll-forward disclosure in SFAS 157 (ie a reconciliation of realised and unrealised gains and losses recognised in the period)[4] provides transparency about fair values measured using unobservable inputs.

39 One financial institution indicated that it might be helpful to require that entities disclose what they consider to be 'substantive evidence' used to support fair value measurements derived using unobservable inputs.

40 Another financial institution suggested that additional disclosure about an entity's control processes and risk exposures would be useful. This would presumably be in addition to the suggested qualitative disclosures regarding an entity's policies and processes for controlling risk in paragraph IG15(b) of IFRS 7 and the required disclosures about risk exposures in paragraphs 31-42 of the Standard. This financial institution did not specify what additional disclosure is needed in those areas.

41 Because these were institutions applying US GAAP, they did not address disclosures required in IFRS 7 *Financial Instruments: Disclosures*. Paragraph 28 of IFRS 7 requires entities to disclose information about differences between a transaction price and fair value at inception:

> If the market for a financial instrument is not active, an entity establishes its fair value using a valuation technique (see paragraphs AG74–AG79 of IAS 39). Nevertheless, the best evidence of fair value at initial recognition is the transaction price (ie the fair value of the consideration given or received), unless conditions described in paragraph AG76 of IAS 39 are met. It follows that there could be a difference between the fair value at initial recognition and the amount that would be determined at that date using the valuation technique. If such a difference exists, an entity shall disclose, by class of financial instrument:
>
> (a) its accounting policy for recognising that difference in profit or loss to reflect a change in factors (including time) that market participants would consider in setting a price (see paragraph AG76A of IAS 39); and

[4] The exposure draft of proposed amendments to IFRS 7 *Financial Instruments: Disclosures* (issued 15 October 2008) includes the Level 3 roll-forward requirement.

(b) the aggregate difference yet to be recognised in profit or loss at the beginning and end of the period and a reconciliation of changes in the balance of this difference.

42 The staff thinks it might be useful to add a requirement that entities disclose the reasons for changes in the fair value that are not due to observability. For example, changes in fair value due to an entity's changes in judgement.

43 IFRS 7 does not explicitly require disclosure about an entity's control environment, although it does require qualitative disclosures about risk management and risk exposures as noted in paragraph 40 above. The Expert Advisory Panel report published on 31 October 2008 notes that an entity might consider disclosing information about its control environment (eg price verification procedures and review processes) to help users understand the quality of reported fair values and ascertain why management is satisfied that the values reported are representationally faithful.

## Staff recommendations

44 The staff reiterate the recommendation in favour of Approach 3 (ie require entities to recognise day one gains or losses, if they arise, even when the initial fair value measurement is derived using unobservable inputs) (the SFAS 157 approach).

45 The staff believe that the conceptual arguments in support of Approach 3 (as discussed in paragraphs 74-80 of the Appendix) are sound. Moreover, in view of the feedback received on the practical application of SFAS 157, the staff is convinced that the approach taken in SFAS 157 for day one gains or losses is anything but 'a free for all'. This is evidenced by the nominal incremental earnings effect of the transition from EITF 02-3 to SFAS 157.

46 In the staff's view, entities should recognise day one gains when supported by a clearly articulated and economically sound profit rationale, together with sufficient evidence and robust disclosure about the resulting fair value measurements.

47 The staff think that one way of accomplishing this is to replace the following sentence in paragraph 17 of SFAS 157:

**Replace**: …For example, a transaction price might not represent the fair value of an asset or liability at initial recognition if…

**With**: …For example, a transaction price is generally the best evidence of fair value of an asset or liability at initial recognition unless…

48 Furthermore, the staff question the appropriateness of having different thresholds for different circumstances. For example, is it appropriate to allow initial recognition at fair value for intangible assets acquired in a business combination (a) for which there is no transaction price and (b) which are measured using significant unobservable inputs, but not to allow it for financial assets that have specified contractual amounts?

49 Moreover, the staff believe that the Board should address any concerns it has about the reliability of fair value measurements by determining what to measure at fair value rather than how to measure fair value.

50 The staff believe that the subsequent measurement of deferred amounts (ie how to account for market value adjustments subsequently) should be addressed in the relevant project for each asset and liability for which this issue pertains.[5] For example, the project on reducing complexity in reporting financial instruments would address this issue for financial instruments.

51 If the Board pursues Approach 3, the staff recommend that entities recognise the difference between the carrying amounts and fair values of financial instruments that were initially recognised at the transaction price under IAS 39 as an adjustment to the opening retained earnings balance upon adoption of the IFRS on fair value measurement (which is consistent with the transition requirements in SFAS 157, as noted in paragraph 30 ).

52 If the Board pursues Approach 3, the staff think the following disclosures would give users of financial statements sufficient information about an entity's day one profit recognition:

[5] Market value adjustments might be made, for example, based on observability or other factors that cause a fair value measurement to differ from the transaction price.

a the proposals in the October 2008 exposure draft of improvements to IFRS 7, including the Level 3 roll-forward and the reasons for movements between different levels of the hierarchy;

b the requirements in paragraph 28 of IFRS 7 (see paragraph 41 above), which will be relevant when an entity determines that the threshold for recognising a day one profit has not been met;

c the amount of profit or loss recognised at inception for the period and the level in the fair value hierarchy on which the fair value measurement is based;

d information about the entity's price verification procedures and review processes, including its control environment surrounding that process.

53 Items (c) and (d) above are incremental (at least in part) to current requirements or proposals in IFRS 7.

## Questions for the Board

54 **Does the Board agree that an entity should be required to recognise day one gains or losses even when the initial fair value measurement is derived using unobservable inputs (ie Approach 3)?**

55 **If the Board does not agree with Approach 3, does the Board believe that day one gains or losses should be required when the initial fair value measurement is derived using only observable inputs (ie Approach 2)?**

56 **If the Board does not agree with Approaches 2 and 3, does the Board want to prohibit the recognition of day one gains or losses in all circumstances (ie Approach 1)?**

57 **If the Board agrees with Approaches 1 or 2, would the Board treat financial and non-financial assets and liabilities differently?**

58 **Regardless of the approach taken, does the Board agree that this project should not address the subsequent measurement and recognition of deferred gains and losses?**

59 **Does the Board want to adopt the transition requirements in SFAS 157 related to day one profits or losses for an exposure draft of an IFRS on fair value measurement?**

60 **Does the Board agree with the staff's disclosure recommendation in paragraph 52c and 52d above? Are there any additional disclosures that you think might be useful?**