30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410   Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org   Website: www.iasb.org

International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**February 2009, London**
Project:	**Fair Value Measurement**
Subject:	**Day 1 Gains or Losses (Agenda paper 6B)**

Purpose of this paper

1 The staff have distributed a pre-ballot draft of the proposed exposure draft on fair value measurement (ED) to the Board members for comment. In the pre-ballot pack the staff have noted that the Board should discuss day 1 gains or losses for financial instruments measured at fair value through profit or loss. The staff will include the resulting decisions in the second pre-ballot draft.

2 It is not within the scope of this project to change accounting treatments in other IFRSs. The staff prepared their recommendations with this objective in mind. However, some amendments to IAS 39 are required to ensure that the fair value measurement objective is applied consistently in IAS 39.

3 This paper discusses consequential amendments to IAS 39 relating to day 1 gains or losses and the deposit floor. This paper does not reflect all consequential amendments to IAS 39 because the staff has sufficient input from the Board to draft those amendments.

4 For reference purposes, appendix A contains an example of the changes that this paper proposes to make to IAS 39. This is not the final draft of these changes.

5 The staff recommendations will not

a result in any changes in the measurement of financial instruments at initial recognition.

b significantly change the threshold for day 1 gains or losses.

c affect the accounting treatment for any deferred day 1 gains or losses.

6 The rest of this paper deals with the following subjects:

a financial instruments at fair value through profit or loss (paragraphs 7-18)

b financial instruments not measured at fair value through profit or loss (paragraphs 19-46)

c material for fair value measurement guidance on evidence required to recognise day 1 gains or losses (paragraph 46-49)

Financial instruments at fair value through profit or loss

7 Applying IAS 39, financial assets and financial liabilities at FVPL are measured initially at fair value. IAS 39 states that the transaction price is the best evidence of fair value of a financial instrument at initial recognition. The only exception is if the fair value is:

a evidenced by comparison with other observable current market transactions in the **same** instrument, or

b based on a valuation technique whose variables include **only** data from observable markets. (paragraph AG76A) [emphasis added]

8 In contrast, in the project on fair value measurement, the Board has tentatively decided that:

a the transaction price is the best evidence of fair value at initial recognition unless:

i the transaction is between related parties;

ii the transaction is made under duress or the seller is forced to accept the price in the transaction;

iii 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;

iv the market in which the transaction is made is different from the market in which the reporting entity would sell the asset or transfer the liability.

b if there is evidence that the transaction price does not represent fair value at initial recognition, an entity recognises a day 1 gain or loss, even when the initial fair value measurement is derived using unobservable inputs.

9 The Board has not stated explicitly how it will implement these tentative decisions for the initial measurement of financial instruments that will subsequently be classified as FVPL. The staff believes that the following principles capture the Board's intentions:

a An entity should apply the [draft] IFRS on fair value measurement in determining the fair value of a financial instrument at initial recognition. Thus, fair value at initial recognition equals the transaction price unless one of the factors described in paragraph 8 applies (related parties, duress, different unit of account, different market[1]).

b If the fair value at initial recognition differs from the transaction price, the entity should recognise the resulting gain or loss as income or expense if, and only if, a specified observability criterion is met. (paragraphs 12-17 discuss what that criterion should be.)

c If that observability criterion is **not** met:

i the entity initially measures the financial asset or financial liability at fair value, adjusted to defer the difference between the transaction price and the initial fair value (a deferred gain or loss).

[1] In January, the Board noted that the exit price of some instruments originated for customers, particularly retail customers, may differ from the transaction price at which they are originated.

ii subsequently, as already required by IAS 39 paragraph AG76A, the entity recognises the deferred gain or loss only to the extent that it arises from a change in a factor (including time) that market participants would consider in setting a price. It is beyond the scope of the project on fair value measurement to reconsider the subsequent accounting for these deferred gains and losses.

10 If the observability criterion is not met, the principles described in paragraph 9 will reach the same result as the existing requirements, but by a different route (and there may be a consequential effect on disclosure):

a Applying the existing requirements, the fair value at initial recognition equals the transaction price. (Subsequently, carrying amount will always equal fair value for an asset or liability at FVPL.)

b Applying the principles in paragraph 9, the initial fair value may differ from the transaction price, but the difference would be deferred. (IFRS 7 requires entities to disclose fair value when it differs materially from carrying amount. That would occur if a material gain or loss has been deferred.)

Question for the Board

11 **Should the ED propose the principles described in paragraph 9?**

Observability criterion for recognising day one gains or losses

12 As noted above, IAS 39 prohibits the recognition of a gain or loss at initial recognition unless the gain or loss results from an initial fair value measurement that is:

a evidenced by comparison with other observable current market transactions in the **same** instrument, or

b based on a valuation technique whose variables include **only** data from observable markets. [emphasis added]

13 How do those criteria relate to the fair value measurement hierarchy in the ED? That hierarchy applies to both **inputs** and **entire measurements**. A fair value measurement

is categorised in its entirety “on the basis of the lowest level input that is significant to the fair value measurement in its entirety.”

14 The criterion in paragraph 12a corresponds broadly to the following description of a level 1 input in the draft ED: “quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity can access at the measurement date”.

15 It is less clear how to map the criterion in paragraph 12b to the hierarchy in the ED. The ED describes level 2 inputs as “inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (ie as prices) or indirectly (ie derived from prices). If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. Level 2 inputs include the following:

a quoted prices for similar assets or liabilities in active markets;

b quoted prices for identical or similar assets or liabilities in markets that are not active, ie markets in which there are few transactions for the asset or liability, the prices are not current, or price quotations vary substantially either over time or among market makers (eg some brokered markets), or in which little information is released publicly (eg a principal-to-principal market);

c inputs other than quoted prices that are observable for the asset or liability (eg interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks and default rates); and

d inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs)”.

16 Appendix B to this paper reproduces application guidance from the draft ED giving examples of level 2 and level 3 inputs. That appendix also includes the ED’s proposed definitions of observable inputs and unobservable inputs.

17 The items listed in paragraph 15a-b and some items in 15c correspond roughly to the “data from observable markets” described in paragraph 12b. On the other hand, the

items in 15d and some in 15c do not fit that description. Thus, there is no exact match between the criteria in paragraph 12 and the boundaries between the levels of the fair value hierarchy. The staff has considered 3 approaches:

a Retain the existing wording in IAS 39 for the observability criterion. This would minimise change to existing practice. However, it would result in two different, but overlapping, hierarchies for financial instruments: the 3-level fair value measurement hierarchy and a 2-level hierarchy that determines whether day one gains or losses are deferred (for financial instruments). This may cause confusion and complexity. Therefore, the staff recommends that the observability criteria should be determined by the boundaries between levels of the fair value hierarchy, as discussed further in b and c below.

b Prohibit the recognition of day one gains and losses if the initial fair value measurement is on level 3 of the hierarchy in the draft ED on Fair Value Measurement (ie set the observability criterion at the boundary between levels 2 and 3). The recognition of day one gains and losses would be more frequent than under the existing requirements, for two reasons: (1) day one recognition would result from inputs that are within level 2 but are not "data from observable markets" and (2) day one recognition would occur if some, albeit not significant, inputs are within level 3 of the hierarchy (the existing criterion stipulates that **all** inputs must be from "observable markets"). The staff believes that such a significant change to the existing criterion is beyond the scope of this project.

c Prohibit the recognition of day one gains and losses if the initial fair value measurement is on levels 2 or 3 of the hierarchy in the draft ED on Fair Value Measurement (ie set the observability criterion at the boundary between levels 1 and 2). This would make the recognition of day one gains and losses somewhat less frequent than under the existing requirements, because day one recognition would not result from significant level 2 inputs that are "data from observable markets". The staff recommends this approach because the staff views this as a less significant change to existing practice. In addition, because this would be a less significant change, it would make it simpler to deal with the amendments for instruments that are not at FVPL, as discussed in paragraphs 19-46.

Question for the Board

18 **Should IAS 39 prohibit the recognition at initial recognition of gains or losses (day one gains or losses) resulting from a fair value measurement within levels 2 or 3 of the hierarchy?**

Financial instruments not measured at fair value through profit or loss

19 At its January 2009 meeting the Board decided tentatively that a day 1 gain or loss should not be recognised for financial instruments measured on a basis other than fair value through profit or loss. Deferred gains or losses would be treated in the same way as transaction costs and as other adjustments made in determining the effective interest rate.

20 The following paragraphs consider how that conclusion would apply for various categories:

a Amortised cost (paragraphs 21-25)

b Available-for-sale (paragraphs 26-35)

c Liabilities with a demand feature (paragraphs 36-46)

Amortised cost

21 The comments in paragraphs 21-24 apply to all financial assets and financial liabilities measured at amortised cost:

a held-to-maturity investments

b available-for-sale financial assets.

c most non-derivative financial liabilities (paragraph 47 of IAS 39 lists the exceptions. The staff believes we will not need to consider making consequential amendments for the items covered by those exceptions).

22 For a financial asset or financial liability that will be measured at amortised cost, initial measurement is at fair value plus transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability. At initial

recognition, the practical effect of that requirement depends on the observability criterion discussed in paragraphs 12-17 above:

a If the initial fair value differs from the transaction price and the observability criterion is met, IAS 39 requires the entity to recognise the resulting day one gain or loss, even for financial assets and liabilities that will be carried at amortised cost. Some may find that result surprising. Nevertheless, in the staff's view, it is beyond the scope of this project to change this existing requirement of IAS 39. (As noted in paragraph 17b above, a change in the observability criterion would bring this requirement into play more or less frequently.)

b If there is evidence that the initial fair value differs from the transaction price but the observability criterion is **not** met:

  i The existing requirements of IAS 39 would say that the initial fair value equals transaction price.

  ii The draft ED would say that the initial fair value differs from transaction price. The principles in paragraph 9 would prohibit the entity from recognising the resulting day one gain or loss. This is consistent with the Board's tentative decisions in January.

23 How would subsequent measurement at amortised cost work if a day one gain or loss was deferred? The staff considered two approaches:

a Recognise the deferred gain or loss subsequently to the extent that it arises from a change in a factor (including time) that the market participants would consider in setting a price. This is consistent with paragraph AG76A of IAS 39.

b Include the deferred gain or loss in the initial carrying amount, and then account for it subsequently through the effective interest method in the same way as transaction costs and as other adjustments made in determining the effective interest rate The Board decided tentatively in January to adopt this approach. The staff believes this approach will produce more relevant information because it is more consistent with the amortised cost approach.

Questions for the Board

24 **IAS 39 requires an entity to recognise a day one gain or loss if the initial fair value of a financial instrument differs from the transaction price paid to acquire or incur it and that initial measurement meets the observability criterion discussed in paragraphs 12-17 above. Should the ED propose maintaining that requirement?**

25 **If the observability criterion was not met at inception, should the entity treat the deferred gain or loss in the same way as transaction costs and as other adjustments made in determining the effective interest rate, as tentatively decided by the Board in January?**

Available-for-sale financial assets

26 In January, the Board reached tentative decisions on day one gains and losses for amortised cost, but did not complete an explicit discussion of whether those conclusions would affect the accounting for available-for-sale financial assets (AFS assets). The following paragraphs consider that issue.

27 Consider first what would happen if the initial fair value differs from the transaction price and the observability criterion **is** met. IAS 39 requires the entity to recognise the resulting day one gain or loss in **profit or loss** (**not** in other comprehensive income, OCI) , even for AFS assets. In the staff's view, it is beyond the scope of this project to change this existing requirement of IAS 39. (As noted in paragraph 17b above, a change in the observability criterion would bring this requirement into play more or less frequently.)

28 Now consider what would happen if the initial fair value differs from the transaction price and the observability criterion is **not** met.

a The existing requirements of IAS 39 would say that the initial fair value equals transaction price. That transaction price (plus transaction costs incurred) would form both the initial carrying amount and the base for the subsequent application of the effective interest method. Subsequently:

i Interest using the effective interest method and impairments, if any, would be recognised in profit or loss.

ii Other changes in fair value would be recognised in OCI.

b The draft ED would say that the initial fair value differs from transaction price. The principles in paragraph 9 would prohibit the entity from recognising the resulting day one gain or loss. This is consistent with the Board's tentative decisions in January. However, the Board has not specified whether those principles merely prohibit the recognition of day one gains or losses in profit or loss or also in OCI. The staff has identified no conceptual or practical reason to treat profit or loss and OCI differently in this respect. Therefore the staff recommends that an entity should not recognise these (or any other) day one gains or losses in OCI.

29 If a day one gain or loss was deferred, there are two elements to consider in relation to the subsequent measurement of AFS assets:

a The deferred gain or loss was excluded from the initial carrying amount, and thus affects the effective interest rate. It subsequently affects profit or loss through the effective interest method in the same way as transaction costs (and as other adjustments made in determining the effective interest rate). This effect is consistent with the result of the amortised cost approach. In addition, because there is no corresponding effect on the carrying amount, there is, in effect, an equal and opposite effect on OCI (unless this is counterbalanced by the separate effect described in b below).

b If there is a subsequent change in a factor (including time) that market participants would consider in setting a price, the entity would at that time recognise the related part of the deferred gain or loss. The recognised gain or loss affects OCI. This is consistent with paragraph AG76A of IAS 39.

Questions for the Board

30 **IAS 39 requires an entity to recognise a day one gain or loss if the initial fair value of a financial instrument differs from the transaction price paid to acquire or incur it and that initial measurement meets the observability criterion discussed in paragraphs 12-17 above. Should the ED propose maintaining that requirement?**

31 **Does the Board agree that an entity should not require day one gains or losses in OCI?**

32 **If the observability criterion was not met at inception, should an entity do both of the following on subsequent measurement: (a) apply the effective interest method to deferred day one gains and losses in the same manner as to transaction costs? (b) recognise deferred day one gains or losses to the extent that there is a change in a factor (including time) that market participants would consider in setting a price?**

Financial liabilities with a demand feature

33 Paragraph 49 of IAS 39 deals with financial liabilities with a demand feature. It states that their fair value is not less than the amount payable on demand, discounted from the first date on which repayment of that amount could be required. In January, as part of its scope assessment, the Board concluded that this stipulation (sometimes known as the deposit floor) was not consistent with the proposed definition of fair value because it systematically ignores market participant assumptions about the timing of the payment.

34 Therefore, the Board decided tentatively not to retain the term fair value as a label for the result of applying this measurement. It is also beyond the scope of this project to change the accounting for instruments subject to the deposit floor. It follows that paragraph 49 should be changed to:

a state that the resulting of applying the deposit floor is not fair value. (paragraphs 41-42 discusses a possible consequence for disclosures) b require entities to measure financial liabilities with a demand feature at the lower of:

   i fair value, and

   ii the amount payable on demand, discounted from the first date on which repayment of that amount could be required.

35 There is some overlap between these changes and the changes discussed earlier in this paper. Consider a bank current account in which the depositor deposits CU100, repayable on demand. Suppose that the fair value of the deposit is CU95. Some would analyse this fact pattern as generating a deposit liability of CU100 and an intangible asset of CU5. Others view the “intangible asset” as an artificial construct that is not separate from the deposit and regard the fair value of the deposit as CU95. For now, please adopt the latter view. This simplifies the following discussion but does not affect the staff’s recommendations. It is beyond the scope of this project to choose between the two views expressed in this paragraph.

36 Under paragraph 49 of IAS 39, the deposit floor applies and CU100 is regarded as the fair value of this deposit liability.

37 Under the proposals in the ED and principles in paragraph 9, the initial fair value of the deposit liability is CU95. However, that measurement depends on significant unobservable inputs, notably determining the run-off period. So the observability criterion is not met and the entity must defer the resulting day one gain of CU5 (difference between the transaction price CU100 and the initial fair value CU95). Thus, the entity will still measure the liability at CU100, just at it does under the existing requirements

38 For a typical bank current account, of the type discussed in this example, the deposit floor is arguably redundant. The amount deposited by the depositor is the same as the amount repayable on demand. Moreover, because that amount is repayable, its present value is the same as the amount deposit (except for the effect of non-performance risk). Furthermore, the price another bank would negotiate to take over the deposits is not a level 1 input. Finally, it could be argued that the depositor’s decision to leave the money on deposit is economically equivalent to withdrawing the money every day and

redepositing it immediately. In effect, a new initial recognition event occurs every day. For these reasons, for these deposits, the deposit floor arguably adds nothing to the prohibition on recognising day one gains.

39 Nevertheless, for the following reasons, the deposit floor has some effects beyond those generated by the prohibition on recognising day one gains:

a The fair value of the deposit is less than face amount if non-performance risk exists.

b For some financial liabilities with a demand feature, the transaction price may not equal the present value of the amount repayable on demand. This might be the case if the demand feature does not become effective until a future date (eg the depositor cannot demand payment for a year).

c If a liability is measured at amortised cost, its initial measurement is reduced by transaction costs. The deposit floor typically prevents this.

40 The Board has indicated that it is beyond the scope of this project to remove the effect of the deposit floor. This implies that the deposit floor should be retained. However, it needs to be re-expressed to clarify that it is an adjustment applied **after** determining fair value, not an adjustment made **in determining** fair value.

41 That re-expression means that the fair value of a financial liability with a demand feature may differ from its carrying amount.   However, applying the existing requirements of IAS 39, its fair value of a financial liability is the same as its carrying amount. Thus, if we re-express the deposit floor as an adjustment made after determining fair value, we will trigger a requirement to determine whether the fair value differs from the carrying amount and to disclose it if it is different.

42 For the following reasons, the staff recommends that the Board create a specific exemption from disclosing fair value in such cases:

a As already noted, controversy surrounds the analysis of demand deposits. Some conclude that their fair value is face amount and that there is a separate intangible asset. Others conclude that there is a single liability, whose fair value is often less than face amount. This controversy relates to the identification of the unit of account, rather than to determining its fair value once it is identified. The staff believes resolving this issue is beyond the scope of this project.

b If the Board concluded that there is a single liability whose fair value is often less than face amount, determining its fair value at each reporting date could involve significant cost and effort. The staff believes that more research would be needed to establish whether the resulting benefits would justify the cost and effort. In the staff's view, investigating that issue is beyond the scope of this project.

c If the Board concluded that the fair value of demand deposits is face amount and there is a separate intangible asset, no disclosure requirement would arise.

43 In addition, the staff recommends that the Board should state explicitly that it has not considered in this project whether financial liabilities with a demand feature should be regarded as generating a single item (the liability) or two items (a liability and a separate intangible relating to the estimated run-off of the existing liability).

Questions for the Board

44 **The staff understands the Board's previous conclusion to mean that the deposit floor is applied <u>after</u> determining fair value, it is not an adjustment made <u>in determining</u> fair value. Is the staff's understanding correct?**

45 **If the fair value of a financial liability with a demand feature differs from its carrying amount solely because of the deposit floor, should an entity be exempt from disclosing that fair value?**

46 **Should the Board state explicitly that it has not considered in this project whether financial liabilities with a demand feature should be regarded as generating a single item (the liability) or two items (a liability and a separate intangible relating to the estimated run-off of the existing liability)?**

Material for fair value measurement guidance on evidence required to recognise day 1 gains or losses

47 At its December 2008 meeting the Board discussed day one gains and losses for all assets and liabilities, not just financial assets and financial liabilities. The Board

tentatively decided that an initial measurement at fair value should result in day one gain or loss only if there is evidence of a difference between the transaction price and fair value at initial recognition. Such evidence would include information that is derived principally from or corroborated by observable market data (market-corroborated inputs) and might include, for example, market data for similar assets or liabilities, such as comparison with benchmark indices, correlation with observable inputs and binding offers from brokers. Paragraph 33 of the draft ED incorporates this notion.

48 The staff reviewed this decision in the light of the recommendations in this paper. The staff believes that it is useful to keep this discussion in the ED, framed as a discussion of the reliability of different sources of evidence, rather than a restriction on recognising day one gains or losses that result from the use of fair value. Any such restriction should reside in the IFRS concerned (as the Board proposes for IAS 39).

Question for the Board

49 **Should the ED retain a discussion along the lines indicated in the previous two paragraphs?**

APPENDIX A

Possible drafting for consequential amendments to IAS 39

This appendix shows a working draft of amended wording for paragraphs 43 and 49 that would implement the staff recommendations in this paper.

For reference purposes, this appendix also includes paragraphs AG6, AG64, AG76 and AG76A

Measurement

Initial measurement of financial assets and financial liabilities

~~**43 When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.**~~

43 When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value, adjusted as follows:

a. **to exclude any difference between (i) a fair value categorised within levels 2 or 3 of the fair value measurement hierarchy described in IFRS X *Fair Value Measurement* and (ii) the price for which the entity acquired the financial asset or incurred the financial liability;**

b. **in the case of a financial asset or financial liability not at fair value through profit or loss, to add (deduct) any transaction costs that are directly attributable to the acquisition (issue) of the financial asset (liability).**

c. **in the case of a financial liability with a demand feature, to apply the restriction imposed by paragraph 49.**

~~49 The fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.~~

<u>49 For a financial liability with a demand feature (eg a demand deposit), whenever this standard refers to a measurement at, or based on, fair value, that reference shall be applied as if it referred to the higher of:</u>

<u>(a) fair value; and</u>

<u>(b) the amount payable on demand, discounted from the first date that the amount could be required to be paid.</u>

[Paragraph AG6 included here for information. In drafting, we will consider adding a statement that similar principles would to any deferred day one gain or loss.]

AG6 When applying the effective interest method, an entity generally amortises any fees, points paid or received, transaction costs and other premiums or discounts included in the calculation of the effective interest rate over the expected life of the instrument. However, a shorter period is used if this is the period to which the fees, points paid or received, transaction costs, premiums or discounts relate. This will be the case when the variable to which the fees, points paid or received, transaction costs, premiums or discounts relate is repriced to market rates before the expected maturity of the instrument. In such a case, the appropriate amortisation period is the period to the next such repricing date. For example, if a premium or discount on a floating rate instrument reflects interest that has accrued on the instrument since interest was last paid, or changes in market rates since the floating interest rate was reset to market rates, it will be amortised to the next date when the floating interest is reset to market rates. This is because the premium or discount relates to the period to the next interest reset date because, at that date, the variable to which the premium or discount relates (ie interest rates) is reset to market rates. If, however, the premium or discount results from a change in the credit spread over the floating rate specified in the instrument, or other variables that are not reset to market rates, it is amortised over the expected life of the instrument.

[Paragraphs AG64 and AG65 included here for information, with some draft wording for consequential amendments.]

Initial measurement of financial assets and financial liabilities (paragraph 43)

AG64 If part of the consideration given or received for a financial instrument is for something other than that instrument, the fair value of the financial instrument is estimated, using a valuation technique (see IFRS X). For example, the fair value of a long-term loan or receivable that carries no interest can be estimated as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. Any additional amount lent is an expense or a reduction of income unless it qualifies for recognition as some other type of asset.

AG65 If an entity originates a loan that bears an off-market interest rate (eg 5 per cent when the market rate for similar loans is 8 per cent), and receives an up-front fee as compensation, the entity recognises the loan at its fair value, ie net of the fee it receives. The entity accretes the discount to profit or loss using the effective interest rate method.

[Paragraphs AG76 and AG76A included here for information. In drafting, we expect to delete these paragraphs, as well as all or much of paragraphs AG69-AG82, because they would be covered by the [draft] IFRS on fair value measurement. We will consider moving AG76A, with modifications, to the section on initial measurement – AG64-65.]

Fair value measurement considerations (paragraphs 48–49)

No active market: valuation technique

AG76 Therefore, a valuation technique (a) incorporates all factors that market participants would consider in setting a price and (b) is consistent with accepted economic methodologies for pricing financial instruments. Periodically, an entity calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument (ie without modification or repackaging) or based on any available observable market data. An entity obtains market data consistently in the same market where the instrument was originated or purchased. 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.

AG76A 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.

APPENDIX B

Defined terms used in the [draft] IFRS

observable inputs	Inputs that reflect the assumptions that market participants would use when determining an appropriate price for the asset or liability developed on the basis of available market data.
unobservable inputs	Inputs that reflect the assumptions that market participants would use when determining an appropriate price for the asset or liability developed on the basis of the best information available.

Fair value hierarchy

Level 2 inputs

B1 Examples of Level 2 inputs for particular assets and liabilities follow.

(a) *Receive-fixed, pay-variable interest rate swap based on the LIBOR swap rate*. A Level 2 input would include the LIBOR swap rate if that rate is observable at commonly quoted intervals for the full term of the swap.

(b) *Receive-fixed, pay-variable interest rate swap based on a foreign-denominated yield curve*. A Level 2 input would include the swap rate based on a foreign-denominated yield curve that is observable at commonly quoted intervals for substantially the full term of the swap. That would be the case if the term of the swap is 10 years and that rate is observable at commonly quoted intervals for 9 years, provided that any reasonable extrapolation of the yield curve for year 10 would not be significant to the fair value measurement of the swap in its entirety.

(c) *Receive-fixed, pay-variable interest rate swap based on a specific bank's prime rate*. A Level 2 input would include the bank's prime rate derived through extrapolation if the extrapolated values are corroborated by observable market data, for example, by correlation with an interest rate that is observable over substantially the full term of the swap.

(d) *Three-year option on exchange-traded shares*. A Level 2 input would include the implied volatility for the shares derived through extrapolation to year three if (1) prices for one- and two-year options on the shares are observable and (2) the extrapolated implied volatility of a three-year option is corroborated by observable market data for substantially the full term of the option. In that case, the implied volatility could be derived by extrapolating from the implied volatility of the one- and two-year options on the shares and corroborated by the implied volatility for three-year options on comparable entities' shares, provided that correlation with the one- and two-year implied volatilities is established.

(e) *Licensing arrangement*. For a licensing arrangement that is acquired in a business combination and that was recently negotiated with an unrelated party by the acquired entity (the party to the licensing arrangement), a Level 2 input would include the royalty rate at inception of the arrangement.

(f) *Finished goods inventory at retail outlet*. For finished goods inventory that is acquired in a business combination, a Level 2 input would include either a price to customers in a retail market or a wholesale price to retailers in a wholesale market, adjusted for differences between the condition and location of the inventory item and the comparable (similar) inventory items so that the fair value measurement reflects the price that would be received in a transaction to sell the inventory to another retailer that would complete the requisite selling efforts. Conceptually, the fair value measurement shall be the same, whether adjustments are made to a retail price (downward) or to a wholesale price (upward). Generally, the price that requires the least amount of subjective adjustments shall be used for the fair value measurement.

(g) *Building held and used*. A Level 2 input would include the price per square metre for the building (a valuation multiple) derived from observable market data, eg multiples derived from prices in observed transactions involving comparable (similar) buildings in similar locations.

(h) *Cash-generating unit*. A Level 2 input would include a valuation multiple (eg a multiple of earnings or revenue or a similar performance measure) derived from observable market data, eg multiples derived from prices in observed transactions involving comparable (similar) businesses, considering operational, market, financial and non-financial factors.

Level 3 inputs

B2 Examples of Level 3 inputs for particular assets and liabilities follow.

(a) *Long-dated currency swap*. A Level 3 input would include interest rates in a specified currency that are not observable and cannot be corroborated by observable market data at commonly quoted intervals or otherwise for substantially the full term of the currency swap. The interest rates in a currency swap are the swap rates calculated from the respective countries' yield curves.

(b) *Three-year option on exchange-traded shares*. A Level 3 input would include historical volatility, ie the volatility for the shares derived from the shares' historical prices. Historical volatility typically does not represent current market participant expectations about future volatility, even if it is the only information available to price an option.

(c) *Interest rate swap*. A Level 3 input would include an adjustment to a mid-market consensus (non-binding) price for the swap developed using data that are not directly observable and that cannot otherwise be corroborated by observable market data.

(d) *Decommissioning liability assumed in a business combination*. A Level 3 input would include expected cash flows (adjusted for risk) developed using the reporting entity's own data if there is no reasonably available information that indicates that market participants would use different assumptions. That Level 3 input would be used in a present value technique together with other inputs, eg (i) a risk-free interest rate or (ii) a credit-adjusted risk-free rate if the effect of the reporting entity's credit standing on the fair value of the liability is reflected in the discount rate rather than in the expected cash flows.[2]

(e) *Cash-generating unit*. A Level 3 input would include a financial forecast (eg of cash flows or earnings) developed using the reporting entity's own data if there is no reasonably available information that indicates that market participants would use different assumptions.