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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **January 2009, London**

Subject: **Fair Value and IAS 39 (Agenda paper 20)**

1. Our discussions with other staff, Board members, and observers at yesterday's meeting lead us to the conclusion that the Board's decision on initial measurement in IAS 39 was unclear. This is especially true given the comments by Jim and David following the vote. We would like the Board to reconsider and clarify its view during Board week, and we have a proposal that we believe satisfies the core principles of IAS 39.

2. In our view, initial measurement at fair value is a core principle in IAS 39. Removing that principle and introducing another significantly weakens the document. However, IAS 39 has a second principle that is not as clearly stated – no gain or loss at initial recognition if subsequent accounting is to be at amortized cost. Those two principles are already in conflict with one another, so IAS 39 already modifies the core principle when applying it to loans, receivables, and held-to-maturity instruments.

3. Let's start with what IAS 39 currently says about initial 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.
44 When an entity uses settlement date accounting for an asset that is subsequently measured at cost or amortised cost, the asset is recognised initially at its fair value on the trade date(see Appendix A paragraphs AG53–AG56).

4. Paragraph AG6 tells the preparer that to implement the effective interest rate method, the entity must then add “any fees, points paid or received, transaction costs and other premiums or discounts” not already included in the amount produced by paragraph 44 of IAS 39 and compute the effective rate. IAS 39 does not state whether those amounts are reported in the carrying amount of the financial instrument or as separate deferred debits or credits. We understand that they are typically added to the carrying amount of the loan.

5. So the amount that is reported on initial recognition is not fair value. It is fair value, plus or minus a series of adjustments. But here’s the key. All of those adjustments would still be necessary if the Board adopted transaction price as the underlying measurement objective. All of those adjustments are designed to meet the second principle – no gain or loss on initial recognition for this class of instruments.

6. We can see several approaches that would preserve both of the principles – fair value and no gain/loss.

    a. Leave paragraph 43 unchanged. Add “any gain or loss resulting from application of fair value on initial recognition,” to paragraph AG6. That has the disadvantage of potentially requiring an entity to make a measurement and then defer the result. However, nothing in the Board’s decision changed the requirement to disclose fair value.

    b. Leave paragraph 43 unchanged. Add a paragraph that says, “In applying fair value to these instruments, any gain or loss that might result from the application of (Paper 3, paragraph 16. a. iii. or iv.) shall not be recognized.” This has the disadvantage of sending preparers off to look for the applicable sections of a different standard.

    c. Add the following to paragraph 43: “Unless otherwise required elsewhere in this standard, initial accounting for financial instruments not at fair value through profit or loss shall not give rise to a gain or loss on initial recognition.”

    d. Add the language proposed in c. to a paragraph that follows paragraph 43 and is not presented in bold type.

7. If we are right in viewing fair value at initial recognition as a core principle in IAS 39, then any of these approaches is consistent with the Board's previous work on principles-based standards. That is, all start from the principle and then identify exceptions. All would result in the same net carrying amount at initial recognition, the same effective interest rate, and the same set of subsequent measurements.