Project **Fair Value Measurement**

Topic **Recognition of day 1 gains or losses**

Purpose of this paper

1. This paper addresses the recognition of gains or losses when a transaction price differs from fair value at initial recognition (day 1 gains or losses) for financial instruments. The recognition of day 1 gains or losses is one of the differences between the IASB's exposure draft *Fair Value Measurement* and FASB Accounting Standards Codification Topic 820 (Fair Value Measurements and Disclosures).[1]

2. This paper is organised in two parts:

   (a) **Part 1** asks the IASB whether to address the recognition of day 1 gains or losses in the fair value measurement project.

   (b) **Part 2** will be discussed only if the IASB agrees to address day 1 gains or losses as part of this project. **Part 2** asks the IASB whether to require the recognition of day 1 gains or losses when fair value is measured using a valuation technique with unobservable inputs.

[1] Topic 820 codified Statement of Financial Accounting Standards No. 157 *Fair Value Measurements*.

3. This paper does not ask the FASB to consider reverting to a prohibition on day 1 gains or losses when fair value is determined using significant unobservable inputs. During the development of FASB Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157), the FASB nullified the guidance in EITF 02-3 'Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Involved in Energy Trading and Risk Management Activities'.[2] Footnote 3 of EITF 02-3 precluded the recognition of a day 1 gain or loss in earnings for derivatives and other financial instruments measured at fair value at initial recognition under FASB Statement of Financial Accounting Standards No. 113 *Accounting for Derivative Instruments and Hedging Activities*.

4. Furthermore, in its deliberations the FASB considered a minimum reliability threshold as a means of limiting day one gains and losses when fair value is determined using significant unobservable inputs. However, its constituents expressed concerns that any such threshold would add complexity in financial reporting. As a result, the FASB rejected the threshold in favour of expanded disclosure requirements for fair value measurements using unobservable inputs.

5. The staff is unaware of the recognition of day 1 gains or losses being a practice issue in the United States. Furthermore, many of the comment letters the IASB received on its exposure draft expressed a preference for their recognition, rather than to continue the prohibition. For example, the larger accounting firms

---

[2] Footnote 3 of EITF 02-3, stated:

> The FASB staff believes that, in the absence of (a) quoted market prices in an active market, (b) observable prices of other current market transactions, or (c) other observable data supporting a valuation technique, the transaction price represents the best information available with which to estimate fair value at the inception of the arrangement. Therefore, in the FASB staff's view an entity should not recognize an unrealized gain or loss at inception of a derivative instrument unless the fair value of that instrument is obtained from a quoted market price in an active market or is otherwise evidenced by comparison to other observable current market transactions or based on a valuation technique incorporating observable market data. For example, a valuation technique that includes extrapolated price curves with little or no observable market inputs for any significant duration of the instrument should not result in an initial fair value estimate that differs from the transaction price for the instrument taken as a whole, because, in this example, the transaction price is the best evidence of the instrument's fair value at that point in time.

support the recognition of day 1 gains or losses if such gains or losses are supportable and appropriate in the circumstances.

6. Even though this paper asks the IASB, and not the FASB, whether it wants to address this as part of the fair value measurement project, the staff thinks it is best for both boards to discuss this jointly. **If the FASB would like to deliberate whether to continue to permit the recognition of day 1 gains or losses for financial instruments, the questions asked of the IASB apply equally to the FASB.**

7. This paper focuses on financial instruments because, except for IAS 39 *Financial Instruments: Recognition and Measurement*, IFRSs require an asset or liability to be measured at its transaction price at initial recognition unless a transaction price is not available. IAS 39 requires that an instrument be measured at fair value at initial recognition even when a transaction price is available. As a result, day 1 gains or losses could arise for financial instruments more often than for other assets or liabilities.

8. The boards have already had detailed technical discussions on this topic in developing the IASB's exposure draft and SFAS 157. As a result, the meeting will focus on analysing the differences between those two documents, the comments received on the IASB's proposals and feedback received about the implementation of Topic 820. This paper does not replicate the analyses already discussed by the boards in developing the IASB's exposure draft and SFAS 157/Topic 820. Board members should contact the staff for the relevant background materials if needed.

Summary of the guidance in the IASB's exposure draft, Topic 820 and IAS 39

The recognition of day 1 gains or losses

9. The IASB proposed in its exposure draft that if an IFRS requires or permits an entity to recognise an asset or liability at fair value and the fair value differs from the transaction price, the entity recognises the resulting gain or loss in profit or loss, unless the IFRS requires otherwise. IAS 39 (discussed below) prohibits the recognition of a day 1 gain or loss unless the fair value of the financial 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* (ie Level 1 and some Level 2 inputs).

10. Topic 820 does not prohibit the recognition of day 1 gains or losses when the transaction price differs from fair value at initial recognition, even if the fair value is measured using a valuation technique with unobservable inputs (ie it can be recognised for Level 1, 2 and 3 measurements).

11. In the FASB's project, Accounting for Financial Instruments, the FASB has tentatively reached the following decisions regarding initial recognition and the recognition of day 1 gains and losses for financial instruments *subsequently measured at fair value*:

    (a) if changes in fair value are recognised in *net income*, the financial instrument would be initially measured at *fair value*. Any difference between the transaction price and fair value at initial recognition would be recognised as a gain or loss in net income.

    (b) if changes in fair value are recognised in *other comprehensive income*, the financial instrument would be initially measured at the *transaction price*. The difference between transaction price and fair value at the first subsequent measurement date would be recognised in other comprehensive income.

Treatment of the difference between the transaction price and fair value

12. IAS 39 addresses the treatment of the difference between the fair value at initial recognition and the transaction price. Paragraph AG76A states that an entity shall recognise the deferred difference as a 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.

13. IAS 39 does not specify the method for recognising the deferred difference. Paragraph BC222 (v)(ii) of the Basis for Conclusions of IAS 39 states:

> ... 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.

14. Because the IASB did not address this in IAS 39, practice varies. Some recognise the deferred difference when inputs become observable; others amortise the difference over the period of the contract.

15. IFRS 7 *Financial Instruments: Disclosures* requires disclosures about the deferred difference.

Part 1: Addressing day 1 gains or losses in the fair value measurement project

Overview of comments received on the IASB's exposure draft

16. The invitation to comment for the IASB's exposure draft asked interested parties whether the proposal to recognise a gain or loss when the transaction price differs from fair value at initial recognition unless the relevant IFRS for the asset or liability requires otherwise is appropriate. For example, as discussed previously, IAS 39 prohibits the recognition of day 1 gains or losses to unless the fair value is evidenced by observable market prices or observable market data. In other words, the recognition of day 1 gains or losses is addressed in other IFRSs, not in the fair value measurement standard.

17. Most respondents strongly recommend that the IASB and the FASB converge on this issue. Some (particularly financial institutions) are concerned that not addressing this issue results in a lack of comparability between US GAAP and IFRS preparers.

18. Many respondents think the scope of this project should include the recognition of day 1 gains or losses on assets and liabilities measured initially at fair value. This is because they believe that day one gains or losses are a direct consequence of a fair value measurement and that the objective of a fair value measurement can be met regardless of the observability of the inputs used in a valuation technique. Furthermore, they believe that treatment of day 1 gains or losses should be consistent for all assets and liabilities measured at fair value (and not on a standard-by-standard basis).

19. However, some respondents think the recognition of day 1 gains and losses should be addressed on a standard-by-standard basis. They are more comfortable recognising day 1 gains or losses for some assets and liabilities (eg agriculture) than for others (eg financial instruments). They also think each standard deals with specific circumstances and the IASB should consider the treatment for each separately.

Staff analysis and recommendation

20. The objective of the IASB's fair value measurement project is to create a single source of fair value guidance and to address 'how to' measure fair value when it is used in IFRSs. The *recognition* of day 1 gains or losses does not influence the *measurement* of fair value.

21. Although the recognition of day 1 gains or losses is outside of the scope of this project, the staff believes the boards need to address this issue for convergence. In US GAAP, Topic 820 does not prohibit the recognition of day 1 gains or losses regardless of whether there is observable market data. IAS 39 prohibits the recognition of day 1 gains or losses unless the fair value is measured using only observable market data.

22. Therefore, the IASB needs to address this issue either in the fair value measurement project (consistent with the FASB's approach) or in IFRS 9 *Financial Instruments: Classification and Measurement*.

23. The staff recommends addressing day 1 gains or losses as part of the fair value measurement project so that the recognition of day 1 gains or losses in the fair value measurement guidance is consistent in US GAAP and IFRSs.

Question 1 – Addressing day 1 gains or losses in the fair value measurement project
Does the IASB agree with the staff recommendation to address the recognition of day 1 gains or losses as part of the fair value measurement project? If not, how does the IASB propose to address the difference between IFRSs and US GAAP for recognising day 1 gains or losses?

Part 2: Day 1 gain or loss differences

(Part 2 will only be discussed if the boards agree to address day 1 gains or losses as part of the fair value measurement project)

Overview of comments received on the IASB's exposure draft

24. As stated previously, IAS 39 prohibits the recognition of day 1 gains or losses unless the fair value is evidenced by observable market prices or observable market data. Although the invitation to comment did not specifically ask interested parties about the appropriateness of this recognition requirement in IAS 39, some respondents commented on it.

25. Some respondents agree with the requirement in IAS 39 to allow day 1 gains or losses only when fair value is based on observable market data or valuation techniques whose variables include only data from observable markets. They believe that:

    (a) a transaction price is the best evidence of fair value

    (b) only observable market data can prove that the transaction price was not the best evidence of fair value, and recognition of day 1 gains or losses when unobservable data is used could reflect model error, not a gain

    (c) this approach will reduce potential abuses of fair value measurements.

26. Respondents raised the following concerns about deferring day 1 gains or losses for fair values using unobservable inputs:

    (a) it implies that a fair value measurement that uses unobservable data is not valid

    (b) the deferral results in a carrying amount that is not fair value

    (c) the subsequent recognition in comprehensive income of the amount previously deferred is not a faithful representation of any real world economic phenomena

(d) the treatment of the deferred amount is complex, costly and unclear and has resulted in diversity in practice

27. Respondents supporting the recognition of day 1 gains or losses regardless of the observability of the market data assert that:

(a) the recognition of day 1 gains or losses in the US is not a ‘free for all’ allowing entities simply to assert that their model price is better than their transaction price, thereby recognising a gain. Rather, there is a relatively high hurdle for recognising day 1 gains or losses[3]

(b) any potential concerns regarding the use of unobservable market data in the valuation of a financial instrument are sufficiently addressed in the (current and proposed) disclosure requirements for instruments in Level 3 of the fair value hierarchy.

Staff analysis and recommendation

28. The fair value measurement objective is the same in all levels of the fair value hierarchy (Levels 1, 2 and 3). That is, to estimate the price at which a transaction would take place in an orderly transaction between market participants at the measurement date.

29. IAS 39 uses a fair value hierarchy that is different from the hierarchy in the IASB’s exposure draft and Topic 820. In IAS 39, the threshold for recognising day 1 gains or losses includes Level 1 and some of Level 2. Level 2 inputs are:

(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 (paragraph B5 provides examples of factors that may indicate that a market is not active)

[3] Furthermore, Agenda Paper 3D from the December 2008 IASB meeting summarises discussions that the staff had with financial institutions regarding what type of evidence would lead them to use a modelled fair value, rather than the transaction price, at initial recognition. The financial institutions indicated that they have instituted policies that require them to ‘prove’ that the entity can reasonably expect to realise the profit (eg through observability of data or experience in past transactions).

(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)

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

30. IAS 39's hierarchy would not consider 'inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs)' in (d) above to be observable market inputs. IAS 39 has the same threshold that was in footnote 3 of EITF 02-3. In effect, the threshold in IAS 39 would consider (d) to be unobservable inputs.

31. The exposure draft proposes that the transaction price is often the best evidence of fair value at initial recognition (Agenda Paper 2E discusses fair value at initial recognition). If an entity determines that the transaction price is not the best *evidence* of fair value at initial recognition, it means that an entity should have other *evidence* that better supports another estimate of fair value. In most situations 'better evidence' would be in the form of observable market data or observable inputs to a valuation technique. However, the staff does not think that the principle of recognising day one gains or losses should be based purely on the observability of market inputs.

32. The staff thinks that because the objectives of a fair value measurement is the same for all levels of the fair value hierarchy, the recognition of day 1 gains or losses should be treated the same for all levels of the fair value hierarchy. In other words, if an asset or liability is measured at fair value at initial recognition and that fair value is determined using a valuation technique that includes any unobservable inputs, the difference between the transaction price and the valuation technique should be recognised as a day 1 gain or loss. But that is only if the valuation technique provides better evidence of fair value than the transaction price.

33. The staff recommends that the IASB remove the prohibition on the recognition of day 1 gains or losses when fair value is measured using a valuation technique with unobservable inputs.

34. In a future meeting the staff will address disclosures about the recognition of day 1 gains or losses.

Question 2 – Recognising a day 1 gain or loss when a valuation technique uses unobservable inputs
Does the IASB agree with the staff recommendation not to prohibit the recognition of a day 1 gain or loss when fair value is measured using a valuation technique with unobservable inputs? If not, what do you propose and why?