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# Day-One results under IFRS

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## Introduction

We have recently participated in several discussions with entities that struggled with accounting for day-one results under IFRS. One would expect the day-one result to be small due to the fact that the transaction prices paid, which are assumed to be accurate evidence for the fair value of financial assets or liabilities. But what if the day-one result is significant? Was there a lucky buy or is it your valuation model that needs finetuning?

We have prepared this article to assist entities in better understanding of and accurately account for day-one results under IFRS.

## What is a day-one result?

Financial assets and liabilities, except for trade receivables, are initially recognised at fair value (IFRS 9.5.1.1). The fair value is normally the transaction price of the asset or liability (IFRS 9.B5.1.1). The transaction price is, generally, the best evidence of the fair value of a financial instrument at initial recognition. However, in some cases there is an exception to this general principle, causing the fair value at initial recognition to differ from the transaction price. This is for example the case when the market in which the transaction takes place is not the principal or most advantageous market, as assumed by IFRS (IFRS 13.16), or simply because one party in the transaction was 'forced' to accept the transaction price due to the circumstances, such as in distressed sale scenario. When the transaction price differs from the fair value at initial recognition, an entity should recognise that difference as result. This result is the so called "Day-one result".

## How to determining the fair value of a financial asset or a liability?

IFRS 13 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The price should be seen as the exit price from the perspective of the market participant that holds the asset or owes the liability at the measurement date (IFRS 13.BC29). IFRS 13 allows three valuation techniques for the measurement of fair value:

- Market approach: Use of prices and other relevant information in market transactions involving identical or comparable assets and liabilities.
- Income approach: The present amount of future cash flows or income and expenses.
- Cost approach: The current replacement cost of for the service capacity of the asset.

The above valuation techniques require inputs which are categorised by IFRS in three different levels, known as the fair value hierarchy:

Level 1: Quoted prices in active markets
Level 2: Observable market data
Level 3: Unobservable market inputs

The level of inputs used to determine the fair value is important for the approach used in the accounting of day-one results.

**How is a day-one result recognised?**
IFRS has different approaches to determine day-one results. The approach to use is based on the level classification of the inputs used for the valuation techniques. This is probably due to the high degree of subjectivity in valuation techniques using level 3 inputs for the calculation of the day-one results and to limit the possibilities of earnings management by the reporting entity.

<u>Level 1 and/or level 2 inputs</u>
When the fair value of a financial asset or financial liability at initial recognition differs from the transaction price and that asset or liability is based only on valuation techniques using level 1 inputs and/or level 2 inputs, the entity shall recognise the difference directly as a gain or loss at initial recognition (IFRS 9.B5.1.2A). This is further referred to as the "day-one result".

The recognition method for financial instruments at fair value using level 1 and level 2 inputs is straight forward. For example if a security with quoted prices (level 1) or a derivative based on observable inputs (level 2) is bought for EUR 100,000 and has a fair value of EUR 101,000 it will be accounted for as follow:

**Journal entry at initial recognition:**

| | Debit | Credit |
|---|---|---|
| Security | EUR 101,000 | |
| Bank account | | EUR 100,000 |
| Unrealised gain security (P&L) | | EUR 1,000 |

<u>Level 3 inputs</u>
When the fair value measurement is based on level 3 inputs, the entity shall defer the difference between the fair value and the transaction price (i.e. only the transaction price is initially recognised as the fair value of the asset or liability). After initial recognition, the entity shall recognise the deferred difference as a gain or loss only to the extent that it arises from a change in factors (including time) that market participants would take into account when pricing the asset or liability (IFRS 9.B5.1.2A). This is further referred to as the "deferred day-one result".

The recognition method for financial instrument measured at fair value based on valuation techniques using level 3 inputs is more complicated than when using level 1 and/or level 2 inputs. The deferred day-one result is recognised as a gain or loss only when the result arises from a change in the factors. Since IFRS does not specify what a change in factors is, this is open to interpretation.

This means that the deferred day-one result at initial recognition is not recognised in the P&L. This result stays "hidden" until the unobservable inputs become observable, and gets recognised:

a) over the period between trade date and the date when the input is expected to become observable; or
b) the life of the trade (when shorter); or
c) the asset is amortised.

We illustrate this using the following example:

Fund X, an investment entity in accordance with IAS 10, purchased Company Y for an amount of EUR 1.5 million. Fund X has its own valuation model which is based on the discounted cashflow method (DCF-method). The Fund's strategy is to exit equity investments in 5 years. The Fund uses estimates for future free cash flows and a discount rate based on the Weighted Average Cost Of Capital (WACC). Based on the DCF-method, Company Y is valued by Fund X at a fair value of EUR 2 million. Fund X would account for the purchase as follow:

**Journal entry at initial recognition:**

| | Debit | Credit |
|---|---|---|
| Company X | EUR 2,000,000 | |
| Bank | | EUR 1,500,000 |
| Deferred result | | EUR 500,000 |

The difference of EUR 0.5 million between the transaction amount and the fair value is the deferred day-one result which is not recognised in the P&L. This result stays "hidden" in the Fund.

A year later, the corporate tax rate for Company Y has changed and this affects the WACC of Company Y. The cost of capital is used as a factor in the discounted cashflow method and is something that would also be used by other market participants. Fund X now values the investment in Company X at a fair value of EUR 2.2 million due to the change in the WACC. The subsequent measurement of Company X will then be as follows:

**Journal entry subsequent measurement after 1 year:**

| | Debet | Credit |
|---|---|---|
| <u>Due to change in WACC factor (2.2m – 2m)</u> | | |
| Company X | EUR 200,000 | |
| Unrealised gain equities (P&L) | | EUR 200,000 |
| | | |
| <u>Due to change in time factor (0.5m / 5)</u> | | |
| Deferred result | EUR 100,000 | |
| Unrealised gain equities (P&L) | | EUR 100,000 |

The result caused by the change in WACC factor is recognised directly in the P&L. The initial EUR 0.5 million deferred day-one result is recognised systematically over the 5 year period.

**How to present day-one results?**

IFRS 7 requires several disclosures when an entity does not recognise a gain or loss at initial recognition of a financial asset or financial liability due to day-one results. The entity should include (IFRS 7.28):

- It's accounting policy for determining when deferred amounts are recognised in the P&L.
- The amounts that still have to be recognised at the beginning and at the end of the period and the changes in these two balances.
- Why the entity concluded that the transactions price was not the best evidence of fair value, including a description of the evidence that supports the fair value.

**How to assess deferred day-one results?**
A valuation model of an entity is based on assumptions and (un)observable inputs. A valuator will assign a value to each of the different inputs used in the model when determining a reasonable estimate of the fair value of a financial asset or liability. This is characterised by a high degree of subjectivity. Ultimately, a valuation model of an entity does not have any value (in terms of usability) when market participants are not prepared to pay the value for the asset or liability as determined by that model. Market prices are generally the best evidence for the value of an asset or liability. This is what market participants are willing to buy or sell for. As indicated in the second paragraph of this article, situations occur where the transaction price is not the fair value of an asset or liability. However, in our opinion the difference between the fair value and the transaction price can't be excessive. If the difference between the fair value and transaction price is (too) large, the entity might want to reconsider its valuation model. A large difference could be an indication of an inaccurate valuation model or incompleteness of the variables used.

Entities should in our view review the inputs used in its valuation model and periodically assess whether they have taken into account all the relevant aspects and consider the possibility of missing important variables. When an entity disposes an asset or liability, it should also use the possibility to review the valuation model by backtesting and performing an analysis of the differences between the fair value and transaction price for the asset or liability upon disposal.

**In summary**
The method for accounting of day-one results is essentially not too difficult. IFRS standards clearly show how to account for day-one results in the financial statements of an entity. Day-one results on financial instruments valued using level 1 or level 2 inputs are rare. These types of assets are generally traded more frequently based on known market prices.

More difficulties will arise with valuations based on level 3 inputs, where deferred day-one results arise. Accounting for the deferred day-one result is not a troublesome issue. However, there is an issue when it comes to the assessment of large (or even excessive) results. When trading a financial instrument in an accessible market it is expected that the transaction price represents the fair value of that instrument. When a financial instrument is valuated much differently than its transaction price, this is in our opinion an important indicator for further improvement of an entities valuation model. Further elaboration of the IASB would be preferable, for instance which factors could also be taken into consideration, other than time.

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