



Tackling HKFRS

Deloitte addresses a financial reporting issue arising from HKAS 39

Question:

HKAS 39 *Financial Instruments: Recognition and Measurement* explains that a financial instrument's transaction price may not be the same as its fair value at the date of initial recognition.

It also provides that, in some circumstances, the financial instrument should be recognized at estimated fair value at the date of initial recognition rather than at the transaction price, and consequently that the difference between such initial carrying amount and the

transaction price be recognized as a "day 1 profit and loss."

What guidance does HKAS 39 provide on initial recognition of the financial instrument in such circumstances and on any unrecognized day 1 profit and loss?

Answer:

The transaction price is normally the best evidence of the fair value of a financial instrument in accordance with paragraph AG64 and AG76 of HKAS 39 *Financial Instruments: Recognition and Measurement*.

An exception to this general rule exists where the fair value of an instrument is evidenced by comparison with other observable current market transactions in the same instrument (i.e. without modification or repackaging) or based on valuation technique whose variables include only data from observable markets.

Where there is strong, market-based evidence of the fair value of the financial instrument, the instrument is initially recognized at the fair value and an immediate day 1 profit and loss may arise.



Using unobservable inputs to calculate a fair value different to the transaction price on day 1 involves a high degree of subjectivity and therefore this cannot be used as fair value on initial recognition of a financial instrument. In such a situation, the instrument is initially recognized at its transaction price, and consequently day 1 profit and loss would not be recognized upon initial recognition.

When day 1 profit and loss has not been recognized for the above reason and therefore included in the initial carrying amount, HKAS 39 requires a gain or loss to be recognized subsequently only to the extent that it arises from a change in a factor (including time) that market participants would consider in setting a price in accordance with paragraph AG76A of HKAS 39.

However, the standards do not further elaborate what constitutes a

change in a factor. Since there is little clarity as to when this “hidden” day 1 profit and loss can be recognized, this day 1 profit and loss could be deferred until all market inputs become observable, or instead released over the life of the instrument on a systematic basis.

For example, a bank charges a fee for issuing a short-term loan commitment within the scope of HKAS 39 that is higher than the bank’s estimate of the fair value of the loan commitment using its proprietary valuation model. The bank does not recognize an upfront gain but measures the derivative loan commitment at the transaction price.

In accordance with paragraph AG76A of HKAS 39, the bank should recognize in earnings observable changes in the fair value of the derivative that have occurred subsequent to initial recognition that a market participant would consider in setting a price. Unless the bank can demonstrate objectively that the fair value of the derivative loan commitment has changed due to changes in mortgage rates or other factors (that would qualify as observable market data) occurring subsequent to initial recognition, the bank should not recognize a change in the fair value of the loan commitment as profit.

To illustrate, the bank received HK\$500 to issue the loan commitment and the bank’s proprietary model

valued the commitment at HK\$300. The bank would initially recognize a derivative liability at HK\$500 equivalent to the cash received. Assume that at the next measurement date, adjusting the valuation model for observable market changes, the estimated value was HK\$200 (a decrease of HK\$100 from the previous model estimate). The bank reduces the derivative liability to HK\$400 and recognizes HK\$100 as a fair value movement in earnings. The initial difference of HK\$200 (HK\$500 minus HK\$300) can be either amortized or deferred (and recognized in profit or loss at the maturity date if the loan commitment was not exercised, or included in the carrying amount of the loan and recognized in profit or loss through the effective interest rate, if the loan commitment was exercised).

In accordance with paragraph 28 and IG14 of HKFRS 7 *Financial Instruments: Disclosures*, if such day 1 profit and loss exists, an entity shall disclose by class of financial instrument a) its accounting policy for recognizing that difference in profit or loss to reflect a change in factors (including time) that market participants would consider in setting a price and b) the aggregate difference yet to be recognized in profit or loss at the beginning and end of the period and a reconciliation of changes in the balance of this difference.