



Project **Financial Instruments: Recognition and Measurement**

Topic **Equity instruments: OCI method**

Introduction

Background

1. At the May 2009 meeting, the Board made the tentative decision to allow presentation of fair value changes for particular financial instruments in other comprehensive income (OCI), but without any subsequent transfers to profit or loss (either on disposal or otherwise). This would eliminate the need to test these instruments for impairment. No reclassification would be permitted – therefore these instruments cannot be measured subsequently at fair value through profit or loss or amortised cost.
2. However, the Board did not discuss which financial instruments would be permitted or required to be measured at fair value with changes recognised in OCI.

Purpose of this paper

3. This paper discusses approaches to identify financial instruments that would qualify for such a presentation of fair value changes.
4. However, the paper only addresses equity instruments in the scope of the financial instruments standard as potential candidates for the OCI presentation of fair value changes. The staff believes that this is what the Board had in mind.

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

IASB Staff paper

For the reasons discussed at the Board meeting, we think all equity investments should be measured at fair value (although see paragraph 7 below).

5. The staff believes that instruments with contractual cash flows are not suitable candidates for OCI treatment in light of the tentative decision not to permit transfers to profit or loss (upon disposal or otherwise). If applied to instruments with contractual cash flows, such as bonds or similar items, that decision would result in no interest revenue ever being recognised in profit or loss. This would contradict the current guidance in IAS 1 *Presentation of Financial Statements* and IAS 18 *Revenue* that require interest revenue to be recognised in profit or loss.
6. The paper does not address:
 - (a) investments that are accounted for pursuant to standards other than IAS 39 (such as IAS 27 *Consolidated and Separate Financial Statements*, IAS 28 *Investments in Associates* and IAS 31 *Interests in Joint Ventures*).
 - (b) how an issuer should account for its own equity instruments. That is being addressed in the boards' project on financial instruments with characteristics of equity and currently, IAS 32 *Financial Instruments: Presentation* contains the relevant accounting guidance.
7. Moreover, the paper does not address the existing accounting for equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured. Paragraph 46(c) of IAS 39 contains an exemption for such instruments and requires that they are subsequently measured at cost (less impairment). This exemption is addressed in Agenda Paper 3B of this Board meeting.
8. **At this meeting, we will ask the Board for a decision on the OCI presentation of fair value changes for equity instruments. A staff recommendation is set out in paragraphs 26-31.**

Objective of a presentation alternative

9. Some investments are strategic in nature and are not purchased solely for, or managed on the basis of, the financial benefits inherent in the equity instrument itself. In some situations, such investments are purchased and subsequently managed because of an enabling role that holding such investments may allow. For example, by holding such investments access to specific markets may be facilitated or eased, hence generating economic benefit to the entity. These investments are sometimes referred to as “strategic” or “long-term” equity investments.
10. A further feature that distinguishes such holdings from other equity investments is that the equity price and/or expected dividend flows are not a, or the only, factor behind a sell or hold decision. That is, decisions about holdings of such stakes are made in a broader business context.
11. Some argue that reporting fair value gains or losses in profit or loss for such holdings are not indicative of the operating performance of the entity. They argue reporting such changes in profit or loss could be confusing to users of financial statements and potentially be misleading.
12. However, every investment involves risks. This particularly is true for equity investments (as they have no contractual cash flows and many possible cash flow outcomes) regardless of the rationale for acquiring them. Hence, even though these investments are made with a different rationale than other equity investments, the staff maintains that carrying them at fair value provides the most useful information to users about the risk inherent in the equity instrument. This is consistent with the Board’s discussions last month.
13. The objective of requiring separate presentation for such investments from trading or other equity investments is to provide the most useful information to users. Separate presentation allows users to easily identify, and value accordingly, such fair value changes.

What equity instruments should separate presentation be applied to?

14. The Board could require all equity instruments to be accounted for at fair value through OCI. However, while simple, a significant drawback of such an approach would be that no fair value change for any equity instrument would ever be recognised in profit or loss (with the possible exception of initial recognition). Under such an approach the fair value changes of instruments that are managed only for the benefits integral to the instrument (as evidenced by the information reported to management in terms of financial position and performance), such as trading positions, would not be reported in profit or loss.
15. This would not provide useful information to users – who often look to apply very low valuation multiples to such, non-recurring, earning streams.
16. To determine which instruments would qualify for OCI presentation the Board has at least two alternatives, namely to:
 - (a) permit an entity to decide, at initial recognition and irrevocably, whether to recognise changes in fair value in profit/loss or OCI; or
 - (b) define the subset of equity instruments whose fair value changes are either permitted (at initial recognition and irrevocably), or required, to be presented in OCI.

Entity decision at initial recognition

17. Under this approach, the reporting entity would be permitted to designate any equity instrument to be reported at fair value with changes recognised in OCI. This decision could be made on an item by item basis or for all “strategic” investments. An entity should reach such a decision if the equity price and/or expected dividend flows is not the principal factor behind a sell or hold decision. That is, decisions about holdings of such stakes are made by the entity in a broader business context.
18. This designation must be made at initial recognition of the instrument. Consistent with the Board’s tentative decision at the May 2009 meeting

reclassifications would not be permitted. Accordingly, the designation would be irrevocable, which would impose some discipline around the designation to avoid earnings management using reclassifications.

19. The Board's tentative decision to not permit any gains or loss to be recycled to profit or loss also imposes some discipline because once the designation is made no gain or loss can ever be recognised in profit or loss subsequently. This avoids creating a facility to "park" gains or losses arising from fair value measurement in OCI until sold, and realised when and if desired.¹
20. To make transparent what instruments are accounted for in OCI, and the impact that accounting had on the financial statements, additional disclosures would be required. Such disclosures, at a minimum, would include:
 - (a) which equity instruments have been designated to be measured at fair value with changes through OCI, including the reason for using this presentation and the fair value at the end of reporting period;
 - (b) fair value gains and loss recognised in OCI for all periods presented; and
 - (c) the total amount transferred from OCI to retained earnings for equity instruments sold during the reporting period, including reasons for any disposals.

Defining a subset of qualifying equity instruments

21. A second approach to identify equity instruments whose fair value changes should be presented in OCI is to define that subset. Under this approach, guidance would have to be developed that sets out which equity instruments

¹ An example: Under the proposed model of the derecognition ED a repo transaction would be accounted for as a sale in particular circumstances. In that case the entity could influence when to recycle a gain or loss in OCI by entering into a repo agreement.

qualify (a positive definition). Alternatively, the Board could define which equity instruments do not qualify (a negative definition).²

22. If a positive definition approach is pursued the Board would have to define the equity instruments that it believes appropriate to report fair value changes in OCI. A further decision would have to be made whether to require or permit the fair value changes of such equity instruments to be presented in OCI. (This could be addressed, however, if a fair value through profit or loss option is available for all financial instruments.)
23. To help develop a set of criteria that identifies equity instruments that are different enough in nature to justify a different presentation of fair value changes some or all of the following qualitative indicators could be used:
 - (a) the primary reason for entering into the investment is not to realise the financial benefits inherent in the equity instrument (ie, dividends and changes in value). Instead, the equity instrument enables the entity to realise other benefits. For example, investments in entities in a specific market or jurisdiction to facilitate access to this market or jurisdiction increasing revenue (or reducing cost);
 - (b) the investment is not managed and evaluated on a fair value basis, as evidenced by the information reported to management; or
 - (c) the investment provides a degree of influence/involvement that is beneficial to the entity, but does not establish significant influence as defined in IAS 28.
24. However, such a list of indicators can never be exhaustive enough to cover all possible scenarios and factors³. That is, it could only be a list of examples of indicators. Further, any application of qualitative criteria to particular situations will always involve a significant degree of judgement.

² This approach is not described further in this paper as it essentially mirrors the points below.

³ Alternatively, the Board could provide a conclusive list, running the risk of not capturing all qualifying instruments under the objective.

25. In addition to the disclosures set out in paragraph 20 of this paper, further disclosures would be required to explain to users how the reporting entity reached the conclusion that the fair value changes of some of its investments in equity instruments qualify for, or are required to be, presented in OCI.

Staff recommendation

26. **The staff recommends allowing an entity to designate equity investments whose fair value changes can be presented in OCI. This choice should be available on an item by item basis and be accompanied by appropriate disclosures.**
27. An entity's rationale behind the designation of such equity investments would be that the equity price and/or expected dividend flows is not the principal factor behind a sell or hold decision. That is, decisions about holdings of such stakes by the entity are made in a broader business context.
28. As no recycling mechanisms would be established, which reduces complexity compared to today's accounting for available-for-sale equity instruments, there is no incentive for management to designate any equity instruments that are managed on a fair value basis as the instrument's performance would never be reported in profit or loss. This is based on the assumption that management would only undertake an investment managed on that basis if it expects that it generates benefits and these benefits are reported in profit or loss.
29. Conversely, many of the equity instruments that management does not manage on a fair value basis, because they have been entered for strategic purposes (in the context of the overall business strategy) would probably be chosen for OCI presentation to avoid the operating performance of the reporting entity being affected directly by investments that are not part of the reporting entity's operating activity.
30. To further strengthen discipline around the designation and increase transparency, disclosures would be required as described in paragraph 20.

31. The staff notes that the alternative, defining the subset of equity instruments, would inevitably also require significant judgement. Thus, in some ways, it is little different than the staff recommendation which involves judgement in deciding whether to designate an equity instrument. Further, a significant amount of application guidance would be required describing the factors (indicators) to consider when performing an assessment.

Questions to the Board

1. Does the Board agree with the staff recommendation in paragraph 26? If not, what approach do Board members want to require, and why?
2. Does the Board agree with the disclosures proposed in paragraph 20? If not, what disclosures would Board members require, and why?