Project **Financial Instruments: Recognition and Measurement**

Topic **Equity instruments: OCI method – follow up**

Introduction

Background

1. At the May 2009 meeting, the Board made the tentative decision to allow presentation of fair value changes for particular equity 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. Reclassifications would not be permitted.

2. At the 1 June 2009 meeting, the Board continued its discussions. Under the approach recommended by the staff at that meeting, an entity would have the irrevocable option to designate any equity instrument as at fair value through OCI.[1] Additional disclosures were proposed to supplement the designation.[2]

3. At that meeting, the Board asked the staff to consider developing a principle when equity instruments qualify for OCI presentation and to contrast such an approach against the designation approach as proposed by the staff.[3]

4. Furthermore, Board members have identified two issues that arise as a consequence of the accounting for equity instruments measured at fair value

[1] See agenda paper 3A of the 1 June 2009 Board meeting, pars. 17-20.
[2] See agenda paper 3A of the 1 June 2009 Board meeting, par. 20.
[3] See agenda paper 3A of the 1 June 2009 Board meeting, par. 26.

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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.

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through OCI they wished to be discussed before reaching a conclusion. These issues were:

(a) applicability of the method on an instrument by instrument basis; and

(b) recognition of dividends.

Purpose of this paper

5. At this meeting, we will ask the Board for a decision on the approach to be taken for OCI presentation of fair value changes for equity instruments. The paper contains staff recommendations on the approach to be taken on the OCI method and the two other issues raised by Board members. We ask Board members to raise any questions or concerns with the staff in advance of the main June meeting in order to meet the timeline for this phase of the financial instruments project.

Using a principle to determine the qualifying equity instruments

6. The basic characteristics of the designation approach (as proposed by the staff at the 1 June 2009 Board meeting) were that:[4]

(a) the entity is allowed to designate any equity instrument on initial recognition as at fair value through OCI;

(b) the decision can be made on an instrument by instrument basis (ie, a reporting entity can have the same equity instruments measured at fair value through income or through OCI);

(c) once the designation is made it is irrevocable;

(d) any subsequent fair value gains or losses are recognised in OCI;

[4] For details and background information see Agenda Paper 3A of the 1 June 2009 Board meeting.

(e) on derecognition of the equity instrument, any amount recognised in OCI is transferred to retained earnings; and

(f) disclosures would be required to make transparent why an entity has invoked the option and what the effects on financial statements have been.

7. A major advantage of the approach is that no guidance would be required how to identify an equity instrument that would qualify for the OCI method.

8. A major disadvantage of this approach is that no other safeguards are put around the option except for the subsequent accounting (no impairment, no recycling, no reclassifications) and disclosures. Some argue that this in itself creates potential for misuse and impairs comparability between entities.

9. Furthermore, accounting options in general add complexity to financial reporting both for preparers (who have to make a choice) and users (who have to identify how the reporting entity has used the option and assess the impact on the financial statements).

10. At the 1 June 2009 meeting some Board members were concerned about providing an option to designate any equity instrument as at fair value through OCI. Those Board members would prefer to have a principle established that would help entities (and possibly users) to identify which instruments should be reported at fair value through OCI.

11. A possible starting point for such a principle could be:

> "An equity instrument that is held in a broader business context and not primarily for realising the financial benefits inherent in it shall be accounted for as at fair value through other comprehensive income."

12. Any final principle or accompanying application guidance will make clear that equity instruments held for trading purposes can never qualify to be measured at fair value through OCI.

13. A major advantage of having a principle is that it avoids providing an explicit accounting choice. However, as there is a significant degree of judgement

involved in making a decision whether the instrument meets the characteristics spelled out in the principle, it can be considered an implicit accounting option. Put different, judgement is applied, but on a different level.

14. Further, having a principle instead of an option is more in line with the IASB approach to principles-based standards. However, there will be demand for application guidance explaining the principle.

15. Moreover, having a principle raises the question about what happens when the principle does not apply anymore. This inevitably raises the issue of reclassifications – which the Board already tentatively decided not to permit.

16. Following the 1 June 2009 meeting some Board members expressed their concern to the staff over not allowing reclassifications[5] if a principle approach to identification is used. For example, a strategic relationship can develop over a longer period including building up the stake in the investee step by step. On the contrary, entities can abandon existing strategic relationships (which might or might not include a (partial) disposal of the investment). If the Board was to require[6] reclassifications it has three alternatives:

    (a) require reclassifications into the OCI method only;

    (b) require reclassifications out of the OCI method only; or

    (c) require classifications into and out of the OCI method.

17. If an equity instrument is reclassified out of fair value through OCI any amount in OCI should be transferred to retained earnings at that point. If an equity instrument is classified into fair value through OCI fair value changes that have been recognised prior to the reclassification should remain in profit or loss and retained earnings as applicable.

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[5] In this context, reclassification is defined as a switch from recognising fair value changes in OCI to recognising fair value changes in profit or loss (and vice versa).
[6] Staff believes if the principle is met subsequent to initial recognition or is no longer met, reclassifications should, if applicable, be mandatory.

Staff recommendation

18. **On balance, the staff recommends proposing a principle approach in the ED. This would ensure that only for a particular type of equity instruments fair value changes are recognised in OCI and that equity instruments held for trading purposes are measured at fair value through profit or loss. This should be supported by additional disclosures. Further, the staff recommends requiring reclassifications into and out of the OCI method.**

19. A principle approach to identification would help to ensure that equity instruments held in a broader business context are accounted for under the OCI method (ie, it is not a free choice).

20. Assuming a principle approach to identification is used, reclassifications into and out of the OCI method should be required as this would ensure only those equity instruments are accounted for under the OCI method that meet the underlying principle.

21. The staff further recommends requiring the following disclosures explaining the use of the application of the OCI method:

    (a) which equity instruments are measured at fair value with changes through OCI, explaining the reason why the equity instruments met the principle, and the fair value at the end of reporting period;

    (b) fair value gains and losses recognised in OCI for all periods presented;

    (c) the total amount of equity instruments classified into and out of the fair value through OCI category and the reasons for any reclassifications, including the total amount reclassified from OCI to retained earnings as a result of reclassifications out of fair value through OCI; and

    (d) the total amount transferred from OCI to retained earnings for equity instruments sold during the reporting period, including reasons for any disposals.

Question to the Board
Does the Board agree with the staff recommendation in paragraph 18 and the proposed disclosures in paragraph 21? If not, what approach do Board members want to require, and why?

Other issues

Applicability of the method on an instrument by instrument basis

22. At the last meeting, some Board members requested clarification whether the assessment of the requirement of an equity instrument to be accounted for under the OCI method would be applied on an instrument by instrument basis or to all equity instruments of the issuing entity held by the reporting entity.

23. The Board has two alternatives to address this issue:

    (a) require application on an instrument by instrument basis

    (b) require application to all equity instruments from the same issuing entity held by the reporting entity

24. The issue is of less relevance if reclassifications are applicable.

25. The staff recommends applying the assessment on an instrument by instrument basis. The staff believes this would reflect best the business rationale for acquiring an equity instrument. The rationale for acquiring equity instruments from the same issuing entity can be different across a diversified reporting entity and requiring all such instruments to be reported on the same basis does not provide useful information to users (eg, an entity can, in theory, hold some shares for trading purposes and others for establishing a long-term relationship).

Question to the Board
Does the Board agree with the staff recommendation in paragraph 25? If not, what do Board members wish to do, and why?

Recognition of dividends

26. At the 1 June 2009 meeting there was some confusion about where to recognise any dividends received from equity instruments designated as at fair value through OCI. As no change to IAS 18 *Revenue* was proposed by the staff, dividends would have to be recognised, under the existing guidance in IAS 18 and IAS 1 *Presentation of Financial Statements*, in profit or loss. However, many Board members were concerned over this accounting treatment. To address this issue the Board could propose a consequential amendment to IAS 18 to exclude equity instruments held by the entity and accounted for as at fair value through OCI from the revenue recognition requirements. This would result in the following journal entry once the right to receive payment is established:

    Dr Dividend receivable

    Cr OCI

27. Alternatively, the Board could keep the existing guidance and allow recognition of dividend income in profit or loss.

28. The staff wishes to highlight that a similar issue already arises under today's requirements for available-for-sale equity instruments where dividends are recognised in profit or loss, but any change in fair value (whether related to the dividend payment or not) is recognised in OCI, unless the equity instrument is considered to be impaired.

29. **The staff recommends amending IAS 18 to exclude dividends received or receivable for equity instruments accounted for under the OCI method from the revenue recognition guidance – dividend income would have to be included in OCI once the right to receive payment is established. The staff believes recognising dividends in the income statement would contradict the underlying rationale for having an OCI method.**

Question to the Board
Does the Board agree with the staff recommendation in paragraph 29? If not, what do Board members wish to do, and why?