Contact(s)	**Liz Figgie**	efiggie@iasb.org	+44 (0)20 7246 6925
	David Humphreys	dhumphreys@iasb.org	+44 (0)20 7246 6410

Project	**Financial Instruments: Replacement of IAS 39**
Topic	**Classification and measurement: Instruments measured at fair value through other comprehensive income**

Purpose of this paper

1. The exposure draft *Financial Instruments: Classification and Measurement* (ED) proposes two primary measurement categories—fair value through profit or loss (FVTPL) and amortized cost.

2. As an **exception** to that classification model, the ED proposes to permit an entity to make an irrevocable election at initial recognition to present in other comprehensive income (OCI), subsequent changes in the fair value of particular investments in equity instruments. This paper refers to that proposal as the "FVTOCI presentation exception".

3. At the meetings on 29 September and 6 October, the Board confirmed the mixed measurement attribute approach proposed in the ED, which measures all financial assets at either FVTPL or amortized cost.[1] However, the Board did not discuss whether there should be any exceptions to that approach.

4. **The purpose of this paper is to ask the Board whether the FVTOCI presentation exception proposed in the ED should be carried forward to the**

[1] At the meeting on 6 October the Board tentatively agreed to require a frozen credit spread measurement method for particular financial liabilities.

IFRS and, if so, whether any of the features or conditions of that exception should be changed.

5. This paper does **not** discuss any other exceptions to the approach for financial assets, such as the cost exception for some unquoted equity investments (and some related derivatives) whose fair value cannot be reliably measured.

Proposals in the ED

6. Paragraphs 21-22 and B24 discuss the FVTOCI presentation exception. Paragraphs BC67–BC75 explain the Board's rationale for that exception. (As background reading, agenda paper 3A for the 1 June extra Board meeting and agenda paper 3B for the regular June Board meeting might be a helpful refresher on its development.)

7. To summarize, the FVTOCI presentation exception has the following features and conditions:

   (a) the election is made at **initial recognition** and is **irrevocable;**

   (b) the election is available on an **instrument-by-instrument basis** and is available for any investment in equity instruments (within the scope of IAS 39), **except** those that are held for trading;

   (c) all **fair value changes** on those equity investments are presented in OCI;

   (d) all **dividends received** on those equity investments are presented in OCI; and

   (e) there are **no subsequent transfers** (ie recycling) of the amounts presented in OCI to profit or loss, and hence, there are **no impairment requirements**. [However paragraph B24 notes that the entity may transfer the cumulative gain or loss (including dividends) <u>within</u> equity.]

8. Additionally the ED proposes amendments to IFRS 7 for disclosures specifically related to the FVTOCI presentation exception. Those disclosures are:

11A If an entity designated investments in equity instruments to be measured at fair value through other comprehensive income, as permitted by paragraph 21 of [draft] IFRS X, it shall disclose:

(a) which investments in equity instruments have been designated to be measured at fair value through other comprehensive income.

(b) the reasons for using this presentation alternative.

(c) the fair value of each such investment at the end of the reporting period.

(d) any transfers of the cumulative gain or loss within equity during the period other than on disposal, including the reason for such transfers.

11B If an entity sold investments in equity instruments measured at fair value through other comprehensive income during the reporting period, it shall disclose:

(a) the reasons for disposing of the investments.

(b) the cumulative gain or loss transferred within equity on disposal, if any.

Relevant questions in the ED

9. Questions 10 and 11 asked about the FVTOCI presentation exception:

Do you believe that presenting fair value changes (and dividends) for particular investments in equity instruments in other comprehensive income would improve financial reporting? If not, why?

Do you agree that an entity should be permitted to present in other comprehensive income changes in the fair value (and dividends) of any investment in equity instruments (other than those that are held for trading), only if it elects to do so at initial recognition? If not,

(a) how do you propose to identify those investments for which presentation in other comprehensive income is appropriate? Why?

(b) should entities present changes in fair value in other comprehensive income only in the periods in which the investments in equity instruments meet the proposed identification principle in (a)? Why?

Feedback received

General feedback

10. Almost all respondents agreed that there should be a FVTOCI presentation exception for particular equity investments. However, almost all respondents expressed concerns about some aspect of the proposals. Those concerns are discussed in more detail below.

11. A small minority of respondents did not support the FVTOCI presentation exception and stated that all investments in equity instruments should be at FVTPL.

12. Also, some respondents were concerned that the Board has not yet addressed OCI comprehensively (ie how OCI should be used and if/when recycling from OCI to profit or loss should be permitted/required).

User feedback

13. Users generally did **not** support the proposals. Primarily they thought that:

    (a) dividends, gains, and losses should be presented in profit or loss at some stage; and

    (b) there should be a principle for this exception—and reclassification should be required based on whether an instrument meets or ceases to meet that principle.

14. Users generally said that if the Board retains the FVTOCI exception, they would favor recycling the items in OCI to profit or loss at some stage. Some users suggested an approach that would recognize dividends in profit or loss immediately and recycle realized gains and losses on derecognition of the instruments—but not require impairment.

15. While many users said that the Board should create a principle for this exception and seemed supportive of basing that principle on a notion of “strategic” investments, other users seemed to support a broader scope for this exception. For example, some users noted that instruments that are held for significant

periods of time but eventually will be sold to realize a gain should be eligible for the FVTOCI presentation exception.

16. A small number of users noted that the current disclosures related to available for sale (AFS) equity instruments are boilerplate and, thus, unhelpful.

***Scope* of the FVTOCI presentation exception**

17. This presentation exception is available for any equity investment (within the scope of IAS 39), **except** those that are held for trading. Most respondents supported that scope because they thought that fair value gains and losses should not be presented in profit or loss if the holder intends to hold the instrument for a medium to long time horizon.

18. However, some respondents that supported the scope asked the Board to confirm that the use of the term "**equity** investment" refers to the definition of equity in IAS 32. For example, a few respondents were uncertain if a puttable instrument that is classified as equity pursuant to IAS 32 would be eligible for the FVTOCI presentation exception.

19. Some encouraged the Board to replace the scope of the FVTOCI presentation exception with a **principle** that would identify a subset of equity investments that are eligible for this exception. Most of those respondents focused on the notion of a "strategic investment", which is discussed in paragraph BC68 of the ED. However many acknowledged the challenges identified by the Board in BC70 of the ED related to developing such a principle (or list of indicators). In their comment letters, respondents did not provide a proposal that was significantly different from the principle discussed by the Board in June 2009.

20. A small number of respondents proposed that the FVTOCI presentation exception should be extended to particular debt investments. Those respondents seemed to prefer the AFS category in IAS 39.

<u>Irrevocability</u> of the FVTOCI presentation exception

21. The ED proposes that the FVTOCI presentation exception is made at initial recognition and is **irrevocable**.

22. The majority of respondents supported that proposal, noting that it:

    (a) is consistent with the fair value option, which must be designated at initial recognition and is irrevocable;

    (b) is consistent with the fact that the scope of the FVTOCI presentation exception is **not** based on the entity's business model for managing the instruments (other than the reference to held for trading); and

    (c) should result in more disciplined use of the exception and avoids potential abuse.

23. A small number of respondents disagreed with the proposal and stated that an entity should be able to reclassify instruments into and out of the FVTOCI presentation exception. In general, those respondents thought such reclassifications should be permitted (or required) if an entity starts or ceases to hold the investments for trading purposes.

Presentation of <u>dividends</u> in OCI

24. Nearly all respondents objected to the proposal that if an entity elects the FVTOCI presentation exception, it must present dividends on those investments in OCI (rather than in profit or loss).

25. These respondents stated that dividends should be in presented in profit or loss for the following reasons:

    (a) Dividends are a form of income and should be presented in profit or loss in accordance with IAS 18 *Revenue*.

    (b) These equity investments are often funded with debt instruments whose interest expense is recognized in profit or loss. As a result, presenting dividends in OCI creates a "mismatch". Some of these respondents, notably listed investment funds, argued that without recognizing dividend income in profit or loss their financial statements would become meaningless to their investors.

26. Some respondents noted that if the Board does **not** carry forward the proposal in the ED but rather decides that dividends shall be presented in profit or loss, that treatment should be limited to amounts that are a return **on** the investment—not amounts that are a return **of** the investment. To do otherwise would result in dividends being presented as revenue and the corresponding decrease in fair value being presented in OCI. While acknowledging this potential abuse, other constituents did not think it would occur frequently enough such that it should drive the treatment of dividends under the FVTOCI presentation exception. Many respondents also noted that they have little, if any, influence over whether dividends on paid on such investments and, if they are paid, the amounts of such dividends.

27. While some respondents said that **both** dividends and realized gains and losses should be presented in profit or loss, many respondents felt stronger about dividends. However, a few of those respondents acknowledged that it would be difficult to justify different treatments for dividends (ie in profit or loss) and other changes in fair value (ie in OCI with no recycling).

No <u>recycling</u>

28. Most respondents did not support the proposal to prohibit recycling of gains and losses into profit or loss when the instrument is derecognized. These respondents stated that **realized** gains and losses should be presented in profit or loss—that is, they support an approach that maintains a distinction between realized and unrealized gains and losses. They stated that an entity's performance should include all realized gains and losses. [Some of those concerns might be reduced if the Board pursues a single statement of total comprehensive income.]

29. Some respondents supported the proposal to prohibit recycling, generally because it:

(a) is consistent with the notion that a gain or loss should be recognized once; thus recognizing a gain or loss in OCI and subsequently in profit or loss is inappropriate;

(b) promotes a more disciplined use of the FVTOCI presentation exception; and

(c) is consistent with the objective of the project to reduce complexity—specifically, it eliminates the need for impairment.

***Alternative* FVTOCI proposal**

30. Given the concerns with the proposals in the ED and the fact that the Board has not yet comprehensively addressed OCI, some respondents suggested retaining the existing requirements for available-for-sale **equity** instruments (at least in the short-term); which would include the following features:

(a) fair value gains and losses would be presented in OCI;

(b) realized gains and losses would be recycled to profit or loss;

(c) impairment testing would be required; and

(d) dividends would be presented in profit or loss.

31. Those respondents noted that the Board should address impairment—either by maintaining the requirements in IAS 39 but requiring reversals or by developing an alternative impairment approach. One such alternative approach was a "lower of cost or market" approach. Under that approach, only fair value changes **above cost** would be presented in OCI. Any changes in fair value **below cost** would be presented in profit or loss. In other words:

(a) there would be **no** impairment trigger because if the instrument's fair value falls **below cost**, that amount would be presented immediately in profit or loss; and

(b) any subsequent increase in fair value **up to cost** would be presented immediately in profit or loss.

Insurance industry

32. Many respondents said that the proposals create particular difficulties for the insurance industry. First, depending on the outcome of phase 2 of the Board's insurance project, there may be a mismatch between the measurement of the insurance company's financial assets and its insurance liabilities. Respondents did not want this project to pre-empt the Board's work on insurance liabilities. Moreover, they were concerned whether (and how) the transition requirements in the insurance project would interact with the classification and measurement requirements in the new IFRS on financial instruments. [This issue obviously is broader than the topic of measuring assets at FVTOCI and we will be asking the Board to consider these issues separately.]

33. Second, respondents noted that insurance companies represent one of the largest groups of long-term investors and the proposals in the ED would either:

    (a) create significant profit or loss volatility (if equity investments are classified at FVTPL); or

    (b) reduce earnings (if equity investments are classified at FVTOCI and thus dividends and realized gains and losses are presented in OCI)

34. Finally, respondents also raised the issue of participating contracts and, in particular, were concerned about mismatches between the treatment of dividends/realized gains on investments and policyholders' participation in those amounts. They noted that for equity investments presented at FVTOCI, policyholder participation should also be presented in OCI (similar to "shadow accounting" in IFRS 4).

Staff analysis and recommendations

35. We do not recommend the alternative FVTOCI proposal discussed in paragraphs 30-31. Consistent with paragraph 30 in agenda paper 3B for the 29 September 2009 board meeting, we do not think maintaining a category similar to (or the same as) the AFS category will result in an improvement to existing requirements. We do not think such an approach would meet the objective of

this project; it would neither significantly improve nor reduce the complexity of the financial reporting for financial instruments.

36. The Board developed this option as an **exception** to the approach, which would apply to particular equity investments; it was not meant to be a third category of financial instruments.

Scope and irrevocability of the FVTOCI presentation exception

Scope

37. Consistent with the views of most respondents, we recommend that the Board carry forward the proposals in the ED that the FVTOCI presentation exception:

    (a) is available for any equity investment that is not held-for-trading; and

    (b) is made at initial recognition and is irrevocable.

38. While we agree that there would be benefits to having a principle for this presentation exception, we acknowledge the Board and staff attempted several times during the ED phase to develop such a principle—and were unsuccessful. That challenge is explained in paragraph BC70 of the ED. We have not received any new information that leads us to believe that it would be simple (or even possible) in the short-term to develop a clear and robust principle. In their comment letters, respondents did not provide a proposal that was significantly different from the principle that the Board discussed (and rejected) in June 2009. In addition, no Board member has been able to suggest an alternative principle to the staff.

39. However, we think that the IFRS should be clear that the term "**equity** investment" refers to the definition of equity in IAS 32, which does **not** include puttable instruments.

40. One Board member asked whether the scope of this FVTOCI presentation exception could result in an entity holding equity shares of an investee and accounting for those shares in three ways—(a) a portion as held for trading, (b) a portion as FVTOCI, and (c) a portion as an investment in an associate (under

IAS 28 *Investments in Associates*). We do **not** think that is possible. The proposed improvements to IAS 28 (published in August 2009) support our view.

41. An investor first determines whether it has significant influence in accordance with IAS 28. If it does, it applies IAS 28. If a portion of the investment in the associate qualifies for the scope exclusion in paragraph 1 of IAS 28 (eg because a portion of the investment is held by a venture capital subsidiary), the entity shall apply the scope exclusion only to the portion to which the scope exclusion applies. That scope exclusion allows a portion of the investment to be classified as held for trading or designated under the fair value option. The remaining investment in the associate shall be accounted for in accordance with IAS 28. No portion of the investment could be classified as FVTOCI.

Irrevocability

42. If this exception is available to all equity investments (except those that are held for trading) we think it is critical that the option is irrevocable to provide discipline to its application. Moreover, prohibiting reclassification is consistent with the Board's decision on reclassifications of instruments designated under the other "option"—the fair value option.

Question 1: FVTOCI-scope and irrevocability
Does the Board agree with the staff recommendation that the FVTOCI presentation exception: (a) is available for any equity investment that is not held-for-trading; and (b) is made at initial recognition and is irrevocable? If not, why? What does the Board want to do instead and why?

Presentation of <u>dividends</u> in OCI and no <u>recycling</u>

Dividends

43. We agree with the majority of respondents that dividends that represent a return on investment should be presented in profit or loss. That is consistent with our original staff recommendation in June, which points to the requirements in IAS

18 *Revenue*, and with existing requirements for dividends received on AFS equity investments in IAS 39 (paragraph 55(b)).

44. We are sympathetic to the concerns discussed in paragraph 25(b)—that is, that these equity investments are often funded with debt instruments whose interest expense is recognized in profit or loss and, as a result, presenting dividends in OCI creates a "mismatch". Furthermore, we accept the point raised in comment letters that the financial statements of some entities, eg listed investment funds, would become relatively meaningless to their investors if dividends are presented in OCI.

45. We acknowledge that an entity may structure a return of investment as a large dividend (and thus present it in profit or loss). We think this is less of a concern because to be within the scope of this approach an entity must be a minority shareholder and therefore unable to influence the dividend policy of the investment. Moreover, we question whether it would occur frequently enough such that it should be a primary driver of the treatment of dividends under the FVTOCI presentation exception. However, we acknowledge that there may be structuring opportunities. As such, we recommend that the IFRS states that dividends that represent a return of investment (ie amounts received that are not in substance dividends) are not presented in profit or loss.

Recycling

46. We recommend that the Board retain the proposal in the ED to **prohibit recycling** of gains and losses from OCI to profit or loss. To do otherwise would be re-creating an AFS category (as discussed in paragraph 35), which would not meet the objective of this project.

47. Moreover, if the Board requires recycling, impairment requirements would be necessary. Such a requirement would increase the complexity of this exception significantly. Moreover, applying the notion of "impairment" to equity investments has always been problematic because it is very difficult to estimate future cash flows.

48. As previously mentioned, the Board developed this FVTOCI presentation exception to accommodate particular types of equity investments. The Board's objective was not to create a broad, third measurement attribute that was the same as the AFS category.

Question 2: FVTOCI-dividends
Does the Board agree with the staff recommendation that dividends should be presented in profit or loss, as long as they represent a return on investment? If not, why? What does the Board want to do instead and why?

Question 3: FVTOCI-recycling
Does the Board agree with the staff recommendation that recycling should be prohibited? If not, why? What does the Board want to do instead and why?

Disclosures

49. We recommend that the Board retain all of the disclosures proposed in the ED, which are reproduced in paragraph 8.

50. In addition, we recommend that the Board also amend IAS 18 to require disclosure of dividends presented in profit or loss related to instruments that are measured at FVTOCI.

Question 4: FVTOCI-disclosures
Does the Board agree with the staff recommendation that: (a) the disclosures proposed in the ED should be retained; and (b) a disclosure should be added for dividends presented in profit or loss that are related to investments that are at FVTOCI If not, why? What does the Board want to do instead and why?