

## STAFF PAPER

March 2017

## IASB Meeting

<b>Project</b>	<b>Financial Instruments with Characteristics of Equity research project</b>		
<b>Paper topic</b>	Summary of interactions with other IFRS Standards		
<b>CONTACT(S)</b>	Manuel Kapsis	<a href="mailto:mkapsis@ifrs.org">mkapsis@ifrs.org</a>	+44(0) 20 72466459

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## Introduction

1. This paper discusses the interactions of the Board's work on the distinction between liabilities and equity in the Financial Instruments with Characteristics of Equity (FICE) research project with other IFRS Standards and other research projects on the IASB's Agenda.
2. Throughout the Board's discussions on the FICE research project we have continuously identified such interactions when relevant. The objective of this paper is to summarise those interactions. Including a discussion of these interactions in the forthcoming Discussion Paper will help inform constituents' responses to the proposals on the distinction between liabilities and equity.

## Background

3. In October 2014 the IASB decided that this project should investigate potential improvements:
  - (a) to the classification of liabilities and equity in IAS 32 *Financial Instruments: Presentation*, including investigating potential improvements to the definitions of liabilities and equity in the *Conceptual Framework*; and

- (b) to the presentation and disclosure requirements for financial instruments with characteristics of equity, irrespective of whether they are classified as liabilities or equity.
4. Instead of starting with a blank sheet of paper and performing a fundamental review, the Board decided to limit the scope of its initial research to financial instruments, in particular IAS 32. If that research identified a need to update or revise the Conceptual Framework, then the Board would need to follow its normal due process for adding a project to its agenda.
5. At its meeting in May 2015, the Board discussed the implications of limiting the scope of its research to IAS 32. The Board observed that the effects of the distinction between liabilities and equity are fundamental aspects of accounting that can be traced back to definitions of the elements in the *Conceptual Framework*. Thus, there are implications from changes in the distinction beyond IAS 32. In Agenda Paper 5B of the May 2015 meeting, the staff provided a preliminary analysis identifying areas that might be affected:
- (a) IAS 32 is one of the IFRS Standards that include requirements for the classification of claims as liabilities or equity. The other IFRS Standard that deals directly with similar classification issues is IFRS 2 *Share-based Payments*. The classification of claims as liabilities or equity in IFRS 2 is consistent with the *Conceptual Framework*. Therefore, if one outcome of the research project is a recommendation to add a project to amend the Conceptual Framework, we will need to consider implications for future revisions to other Standards that might be affected. One of those Standards could be IFRS 2.
- (b) There are other IFRSs that contain requirements that interact with IAS 32 in one way or another. The Board will need to be aware of potential knock-on effects arising from those interactions, including consequential amendments to some of these IFRSs as a result of a standard-level project to amend, or replace, IAS 32.
- (c) There are other projects on the Board's research agenda which may inform, and be informed by, its research in this project. In particular,

these include the Principles of Disclosure project and the Primary Financial Statements project.

6. The objective of this paper is to provide some more information about the potential implications in the areas we have identified based on the Board's preliminary views on the Gamma approach.

### **Staff analysis**

7. The IASB does not typically include details of consequential amendments in Discussion Papers. However, in the staff's view, the Discussion Paper should include a brief discussion of the consequences for some particular areas beyond IAS 32. Such as discussion will summarise:
  - (a) potential changes to requirements in other IFRS Standards as a result of the preliminary views; and
  - (b) potential effects resulting from the application of requirements in other IFRS Standards that currently use, or depend on, the definitions in IAS 32.
8. Many of these discussions will likely be embedded in the analysis of particular sections, for example:
  - (a) the discussions about the underlying rationale of the Gamma Approach will compare that underlying rationale with the Conceptual Framework.
  - (b) the discussions about attribution within equity will discuss interactions with earnings per share.
9. With regard to other relevant projects on the Board's agenda, we will continue to monitor and liaise with other project staff, in particular on the Disclosure Initiative and the Primary Financial Statement project.
10. The rest of the staff analysis of the interactions is structured as follows:
  - (a) The Conceptual Framework and IFRS 2
  - (b) Other existing IFRS Standards and Interpretations

## The Conceptual Framework and IFRS 2

### *The Conceptual Framework*

11. During redeliberations of the Conceptual Framework project, the IASB tentatively decided to further explore how to distinguish liabilities from equity claims in the FICE research project instead of the Conceptual Framework project.
12. The Board intends to publish a revised *Conceptual Framework*. The revised *Conceptual Framework* will include proposed changes to the definition of a liability but will not include any proposed changes to the existing definition of equity. The proposed changes to the definition of a liability are not intended to address challenges relating to the application of the definition to distinguishing liabilities from equity. These challenges have been explored as part of this research project.
13. The Board's discussions in this research project began with an analysis of the concepts that might be used to reinforce the underlying rationale of IAS 32. In those discussions, the Board developed three approaches to the distinction between liabilities and equity:
  - (a) Approach Alpha, which classifies a claim as a liability if it obliges the entity to transfer economic resources at particular points in time other than at liquidation.
  - (b) Approach Beta, which classifies a claim as a liability if it obliges the entity for an amount that is independent of the entity's economic resources.
  - (c) Approach Gamma, which classifies a claim as a liability if it obliges the entity:
    - (i) to transfer economic resources at particular points in time other than at liquidation; or
    - (ii) for an amount that is independent of the entity's economic resources.
14. The Board has decided to focus on the Gamma approach. The most significant difference with the Conceptual Framework is that the Gamma approach considers

one additional feature for classification purposes: whether the amount of the obligation is independent of the entity's economic resources.

15. The Board has previously stated that one possible outcome of the research could be a recommendation to propose an amendment to the Conceptual Framework in relation to distinguishing between liabilities and equity. Thus, depending on the feedback on the Discussion Paper, an outcome of the research may include a proposal to add a project to consider possible amendments to the Conceptual Framework, in addition to a proposal to add a project to amend or replace IAS 32. Any decision to add a project to its Agenda would be subject to feedback on the proposals in the Discussion Paper and the Board's normal Due Process.
16. If the Board decides to add a project to amend the Conceptual Framework, it would also consider the scope of the project, including whether the project will be limited to potential changes in the definitions, or might include additional guidance to support the distinction between liabilities and equity. The Discussion Paper will also include a discussion of other matters that might provide input to such a decision.
17. The other potential difference with the Conceptual Framework is the proposed separate presentation requirements for income and expenses that depend on the residual amount. Under the Gamma Approach, to enhance the relevance and faithful representation of information in profit or loss, one way that the Board is considering presenting such income and expenses will be to use Other Comprehensive Income (OCI), but without recycling to profit or loss. The revised Conceptual Framework will state that in principle income and expenses included in OCI should be recycled to profit or loss when doing so would enhance the relevance or faithful representation of the information in the statement of profit or loss for that period. Income and expenses included in OCI may not be recycled if, for example, there is no clear basis for identifying the period in which recycling should occur or the amount that should be recycled.
18. The staff plan to discuss possible interactions with the *Conceptual Framework* in more detail with the Board in the light of the responses to the Discussion Paper.

## **Share-based Payments**

19. At present, the distinction between liabilities and equity under IFRS 2 is consistent with the revised Conceptual Framework. If the Board does ultimately decide that the Gamma approach is the best underlying rationale for a distinction between liabilities and equity, and proposes changes to the Conceptual Framework as a result, it would need to consider the implications for a future revision to IFRS 2. Any decision to add a project to its Agenda would be subject to the Board's normal Due Process.<sup>1</sup>
20. At present, the inconsistency between IFRS 2 and IAS 32 results in some transactions which are similar being accounted for differently. If the outcome of the research project is a recommendation to add a project to amend the Conceptual Framework to be consistent with the Gamma approach, it might provide an opportunity to improve the consistency between IFRS 2 and IAS 32 in a future project.
21. The separate presentation requirements for both liabilities and equity under the Gamma approach might also be relevant to addressing some of the other challenges that have been identified with IFRS 2. One of those challenges is that IFRS 2 uses two measurement models: grant date fair value for equity-settled share-based payments and reporting date fair value for cash-settled share-based payments.<sup>2</sup> The separate presentation requirements under the Gamma approach might open up some possibilities for reducing the tension between the two measurement models in IFRS 2.
22. If the Board proceeds with an approach that attributes total profit or loss and other comprehensive income to derivatives classified as equity, then it could consider whether such attribution should also be applied more broadly. In particular, if, in the light of the feedback received on the Discussion Paper, the Board decides to consider the implications for earnings per share in more detail (see paragraphs 35-

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<sup>1</sup> We note that the Board has recently undertaken research to identify the most common areas of complexity in accounting for share-based payment transactions, and their main causes, and to assess whether the Board should consider addressing them. In May 2016, the Board decided not to perform any further research on this topic. In addition, the Board identified no need to develop amendments to IFRS 2 as a result of that research.

<sup>2</sup> For further details, see [Agenda Paper 16A](#) of May 2016.

48), it would need to consider consequences for equity-settled share based payments.

23. The staff plan to discuss possible interactions with IFRS 2 in more detail with the Board in the light of the responses to the Discussion Paper.

### **Other existing IFRS Standards and Interpretations**

24. This section includes a discussion of the interactions with:
- (a) Other financial instruments standards and interpretations
  - (b) Performance reporting standards
  - (c) Business combinations and consolidations standards

### ***Other financial instruments standards and interpretations***

25. Other IFRSs and IFRICs that have requirements for the accounting for financial instruments include:
- (a) IFRS 9 *Financial Instruments*
  - (b) IFRS 7 *Financial Instruments: Disclosure*
  - (c) Some Interpretations

#### *IFRS 9 and IFRS 7*

26. The scope of the Discussion Paper is limited to classification, presentation and disclosure. The recognition and measurement requirements of IFRS 9, in particular for financial liabilities (but also for financial assets), are beyond the scope of the project.
27. There are some areas where the classification and presentation proposals interact with the recognition and measurement requirements of IFRS 9 that are going to be discussed in the Discussion Paper. To the extent that the classification and presentation requirements interact with the recognition and measurement requirements, the Board has been consistent with the requirements of IFRS 9. One area of interaction is the application of the separate presentation requirements to stand-alone and embedded derivative financial liabilities that depend on the

residual amount. The Discussion Paper will include an analysis of the interaction of the separate presentation requirements with the fair value option in IFRS 9.

28. If the Board decides to add a project to amend, or to replace, IAS 32, there will likely be consequential amendments to other IFRS Standards that include requirements for financial instruments, including IFRS 9 and IFRS 7. The details of the location of particular requirements and any consequential amendments would be considered as part of the Board's standard setting project if it decides to undertake one.

### *Interpretations*

29. There are two interpretations that are relevant:
- (a) *IFRIC 2 Members' Shares in Co-operative Entities and Similar Instruments*—In February 2017, the Board tentatively decided that it would not reconsider the requirements of IFRIC 2 other than for consequential amendments.
  - (b) *IFRIC 19 Extinguishing Financial Liabilities with Equity Instruments*—IFRIC 19 addresses the recognition and measurement of liabilities as a result of settling the liability by issuing equity instruments. In the staff's view, this Interpretations is beyond the scope of the project as it does not address classification issues.

### ***Performance reporting***

30. The separate presentation requirements that will be proposed in the Discussion Paper will have some consequences for IFRSs which contain requirements for performance reporting. In particular:
- (a) *IAS 1 Presentation of Financial Statements*
  - (b) *IAS 33 Earnings per Share*
31. The potential changes to IAS 1 will be consequential in order to implement the separate presentation requirements.
32. However, the preliminary views on separate presentation for both liabilities and equity might require the Board to consider the effect on IAS 33 in greater detail.



This would be particularly the case for some of the approaches to attribution for derivatives than others. We discuss this in more detail in paragraphs 35-48.

33. The Board does not currently have a project to revise IAS 33. The Board did have a project which resulted in the publication of an Exposure Draft in 2008, however that project was suspended in 2009.
34. One of the challenges identified in the Board's previous project on Earnings per Share is that the interaction between the current requirements of IAS 32 and IAS 33 is unclear, in particular for shares underlying written puts. In February 2017, the Board discussed some application guidance and illustrative examples, in particular for written put options on own equity. That application guidance could be used as a basis to improve the consistency between IAS 32 and IAS 33.

*IAS 33 Earnings per Share and the separate presentation requirements*

35. Earnings per share is calculated by dividing profit or loss attributable to ordinary shareholders of the parent entity (the numerator) by the weighted average number of ordinary shares outstanding (the denominator) during the period.
36. Basic earnings per share is not adjusted for the effects of *potential* ordinary shares (eg warrants) that are dilutive, whereas dilutive earnings per share is adjusted for those effects.
37. In the staff's view, one of the basic principles of calculating a number representing diluted earnings per share, is that the effect of instruments other than ordinary shares should be considered either in the numerator or the denominator. However, that effect should not be included, or excluded, from both. In IAS 33, this is reflected in paragraphs 31 and 32 which require:
  - (a) any effect of dilutive potential ordinary shares that is included in the numerator to be reversed out; and
  - (b) increasing the number of weighted average number of shares in the denominator for the effect of the dilution.
38. There are two aspects of the requirements of IAS 33 that are relevant to the separate presentation requirements under the Gamma approach:
  - (a) The starting point for calculating the numerator of the earnings per share calculation is **total profit or loss**. The calculation ignores items

of income and expense included in other comprehensive income. This has implications for the separate presentation requirements for liabilities (see paragraphs 39–41).

- (b) Adjustments to total profit or loss are made to determine the amount of profit or loss that is **attributable to ordinary equity holders** of the parent entity (the numerator). There are varying degrees of overlap between the calculation required for EPS in determining the numerator and the different approaches to attribution that the Board is exploring as part of the FICE research project (see paragraphs 42–48).

### *Separate presentation requirements for liabilities*

39. Under the Gamma approach, the entity will be required to separately present income and expenses arising from obligations that are classified as liabilities but which depend solely on the residual amount. This is because, economically, the changes in such claims will be similar to the changes in similar claims that are classified as equity. In September 2016, the Board tentatively decided that income and expenses arising from financial instruments that meet the separate presentation requirements, including derivatives on ‘own equity’, should be presented in OCI, however the Discussion Paper will also discuss separate presentation within profit or loss.
40. Presenting such changes in OCI will automatically exclude them from the numerator of the earnings per share calculation. However, the Board might wish to consider whether the effect of instruments that are subject to the separate presentation requirements should be considered in the denominator of the earnings per share calculation.
41. To take a simple example, if an entity has 400 shares that are equivalent, but 100 of them are puttable at fair value, then classifying those 100 shares as liabilities and measuring them at the redemption amount will provide useful information about the potential liquidity requirements of the entity. However, excluding the changes in the redemption amount from the numerator and including the 100 shares in the denominator would present an ‘earnings’ attributable to the 400 shares that reflects the similarity of their returns.

*Attribution within equity*

42. Under the Gamma approach, an entity will be required to attribute total profit or loss and other comprehensive income to some classes of equity other than ordinary shares.
43. For *non-derivative* equity claims the attribution requirements will be consistent with the EPS calculation, therefore there will be no consequences.
44. However, for *derivative equity* claims, the discussion paper will include four possible approaches of attribution for derivatives classified as equity:
- (a) approach A would not result in any attribution;
  - (b) approach B would attribute an amount equal to changes in the fair value of the derivative; and
  - (c) approaches C and D would attribute an amount weighted by the relative fair value of the derivative and the fair values of other classes of equity. Approach C would apply that weighting to the end of period carrying amounts, whereas Approach D would apply that weighting to total profit or loss and other comprehensive income.
45. There are varying degrees of overlap between the calculation required for diluted EPS and the different approaches to attribution under the Gamma approach.
46. Approach A will have no consequences for the earnings per share calculation.
47. In the staff's view, Approach B is also unlikely to have consequences for the EPS calculation, because there is very little overlap between attribution at fair value of the derivatives and the calculation of earnings per share. In the staff's view, the attribution under approach B provides information that supplements the EPS calculation. It is a different aspect of the distribution of the returns that is communicated through the changes in the fair value of those instruments. In addition, using approach B to calculate earnings per share would contradict the rationale for excluding changes in the value of the redemption amount of liabilities that depend on the residual from the numerator of the EPS calculation.
48. In contrast, and as described in the Agenda Paper discussing those approaches, the information provided through approaches C and D overlaps to a greater extent with the calculation of diluted EPS than approaches A and B. The calculation of

attribution under Approach D in particular is similar to that of diluted EPS, however it uses the fair value of the options instead of their intrinsic value. Because of this overlap, these approaches are closer to substitutes to the EPS calculation and could form the basis for a broader review of EPS. Therefore, if the Board ultimately decides to adopt approach C or D, it would also need to decide whether to undertake such a review as part of this project, or wait to add a project on EPS to its Agenda.

### **Business combinations, consolidations and investments in associates and joint ventures:**

49. There are no direct requirements coming from IFRS 3 *Business Combinations*, IFRS 10 *Consolidations*, or IAS 28 *Investments in Associates and Joint Ventures*. However, these standards do contain references to some requirements of IAS 32.
50. In the past, questions have arisen about the consistency between the requirements of IFRS 3, IFRS 10 and IAS 32, in particular for written puts on non-controlling interests. In February 2017, the Board discussed application guidance and illustrative examples under the Gamma approach which would help clarify the interactions between IAS 32 and these IFRS Standards.

#### **Question**

Does the Board agree with the analysis of interactions? Are there any other areas that should be included?