STAFF PAPER

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IASB® meeting

Project	**Financial Instruments with Characteristics of Equity (FICE)**		
Paper topic	Comment letter feedback—Overall objective, scope and challenges		
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Objective

1. This paper summarises the detailed feedback received on Section 1 of the Discussion Paper *Financial Instruments with Characteristics of Equity* (DP), which sets out the objective and scope of the FICE project and the challenges identified by the Board in relation to IAS 32 *Financial Instruments: Presentation*. Section 1 of the DP includes a question on whether respondents think standard-setting is required to address such challenges. Suggestions and recommendations made by respondents on how the Board should progress the proposals in the DP are also summarised in this Agenda Paper.

2. This paper is not asking the Board to make any decisions regarding the FICE project direction or the next steps in taking the project forward. However, the staff have included a question to the Board with regards to whether Board members wants the staff to analyse further any of the proposals in the DP or the feedback received specifically when considering the project direction.

3. This paper is structured as follows:

    (a) Background and questions in the DP (paragraphs 4–5);

(b) Key messages from the feedback received (paragraphs 6–7);

(c) Additional challenges identified by respondents (paragraphs 8–13);

(d) Project directions suggested by respondents (paragraphs 14–27); and

(e) Questions for the Board (paragraph 28).

Background and Questions in the DP

4. Section 1 of the DP sets out the objective and the scope of the project and challenges the Board has identified with respect to IAS 32. The challenges identified include the following:

   (a) *Conceptual challenges*: The Board acknowledged that identifying a rationale for distinguishing liabilities from equity is difficult because of the variety of claims with different features that have different consequences for an entity's prospects for future cash flows. Different features include, for example, the timing of a required transfer of economic resources, the amount of the claim and its priority relative to other claims against the entity. Information about all those features is relevant to users of financial statements and many of those features could form a basis for distinguishing liabilities from equity. Currently, IAS 32, other IFRS Standards and the *Conceptual Framework for Financial Reporting* (Conceptual Framework) all use various features to distinguish liabilities from equity, often without a clear basis for selecting the distinguishing features.

   (b) *Application challenges*: Respondents to previous consultations have suggested that some financial instruments have challenged the consistency, completeness and clarity of the requirements in IAS 32. Some of these challenges are also evident from issues submitted to the IFRS Interpretations Committee (the Committee), some of which remain unresolved. Examples include classification of derivatives on own equity, the application of the fixed-for-fixed condition in particular, accounting for contracts that contain an obligation to repurchase an entity's own equity instruments, accounting for financial instruments with contingent settlement provisions and determining the boundary of contractual terms including the interaction with economic compulsion and laws and regulations.

5. The Board asked the following questions:

> **Question 1**
>
> Paragraphs 1.23–1.37 of the Discussion Paper [summarised in paragraph of this Agenda Paper] describe the challenges identified and provide an explanation of their causes.
>
> (a) Do you agree with this description of the challenges and their causes? Why or why not? Do you think there are other factors contributing to the challenges?
>
> (b) Do you agree that the challenges identified are important to users of financial statements and are pervasive enough to require standard-setting activity? Why or why not?

Key messages

6. **Do respondents agree with the challenges and their causes identified by the Board?** Almost all respondents agreed with the challenges identified by the Board. Many respondents also highlighted other challenges they think the Board should address in addition to those identified by the Board (see paragraphs 8–13).

7. **Do respondents agree that the challenges identified warrant standard-setting?** Almost all respondents supported the Board developing a standard-level solution to address the challenges identified. However, these respondents suggested a wide range of different directions for the project:

   (a) Many respondents suggested making targeted improvements to IAS 32 by amending, clarifying or adding guidance to IAS 32 (paragraphs 15–18).

   (b) Some respondents suggested undertaking a fundamental review to develop an approach to distinguishing liabilities from equity (paragraphs 19–21).

(c) Some respondents supported the Board pursuing a principles-based solution. Some of these respondents suggested proceeding with the Board’s preferred approach to classification subject to clarification of the new terminology used or a closer alignment of terminology and/or the classification outcomes with IAS 32. Some other respondents suggested more significant modifications to the Board’s preferred approach to classification. (paragraphs 22–23).

(d) A few respondents suggested a disclosure-only approach (paragraphs 24–25).

Additional challenges identified by the respondents

8. Many respondents highlighted additional challenges that arise when applying IAS 32 and recommended the Board address these challenges in addition to those identified in the DP. Two most commonly mentioned challenges are described in paragraphs 9–12.

Differentiating the entity from its owners

9. Many respondents referred to the IFRS Interpretations Committee discussion in March 2010 in describing this challenge. At that meeting, the Committee noted that diversity in practice may exist when assessing whether an entity has an unconditional right to avoid delivering cash if the contractual obligation is at the ultimate discretion of the issuer's shareholders and, consequently, whether a financial instrument should be classified as a financial liability or an equity instrument. The Committee did not conclude on this matter and recommended that the Board address this issue as part of the FICE project.

10. A few respondents commented more broadly that it is challenging to determine which transactions are transactions with the owner of the entity in its capacity of owners and which are not, and consequently which gains or losses are recognised in equity rather than in profit or loss.

Subsequent reclassification between liability and equity

11. Many respondents observed that it is unclear in IAS 32 whether an entity is required to reassess the classification of a financial instrument after initial recognition especially when its contractual terms are unchanged. The classification outcome may be different from an initially assessed outcome if there are changes in circumstances including an expiry of a feature of the financial instrument that had prevented equity classification, for example a written put option for cash, or other factors such as a change in the entity's functional currency.

12. A few respondents also said that it is unclear whether the modification of a contract should require reclassification and how such modifications should be accounted for.

Other issues

13. Respondents also highlighted some other challenges. Many of them related to specific topics discussed in the DP and hence have been included in the respective Agenda Papers for the June 2019 and July 2019 Board meetings. The remaining challenges included the following:

    (a) Determining whether an instrument is in the scope of IAS 32 or IFRS 2—respondents noted that the difference in requirements between IAS 32 and IFRS 2 leads to different accounting outcomes depending on which standard is considered applicable, making the scope assessment even more critical. For example, the accounting outcomes could be different when applying IAS 32 and IFRS 2, if a contract can be settled for a variable number of shares, or if an entity has a past practice of settling in cash.

    (b) Unit of account—respondents were of the view that more clarity is required in this regard. For example, it is unclear in IAS 32 whether classification requirements should be applied to each obligation or to a financial instrument as a whole.

Project directions and objective suggested by respondents

14. Almost all respondents who provided feedback on the project direction agreed that challenges are pervasive enough to warrant a standard-level solution but expressed a wide range of different preferences on the extent and direction of standard-setting. A few standard-setting bodies noted that there are split views on the project direction among stakeholders they have undertaken outreach with. Most respondents acknowledged the benefits of having clear principles however, many of them still suggested an approach of rather making more targeted (ie narrower scope) improvements to IAS 32. Some respondents commented on what the project objective should be.

Targeted improvements to IAS 32

15. Many respondents recommended the Board consider making targeted improvement to IAS 32 to address applications issues rather than the proposed approach in the DP, which in their view is a fundamental rewrite of principles.[1] However, many of these respondents acknowledged the benefit of having clear principles, but still suggested making narrower-scope targeted improvements. This is because, in their view, clear principles should ideally require no exceptions and be aligned with other IFRS Standards and/or with the Conceptual Framework, which were not achieved by the approach proposed in the DP. Considering the improvement that would result from applying the approach proposed in the DP, these respondents believed a similar level of improvement to IAS 32 could be achieved though narrower-scope amendments. In their view, such an approach would best strike the balance between addressing accounting diversity in practice while reducing the risk of introducing new interpretation issues and implementation effort. A few respondents even said that they themselves have tried to develop an alternative principles-based approach but was unable to find a consensus. They therefore suggested targeted improvements to IAS 32 as a way forward.

[1] These respondents considered the proposed classification approach in the DP as a fundamental change from IAS 32 mainly due to the resulting changes in classification outcomes and the use of new terminology (see Agenda Paper 5A for the June 2019 Board meeting for further detail).

16. Some of the respondents who supported a targeted improvement approach acknowledged that such an approach has limitations and cannot address all of the existing challenges. For this reason, a few respondents suggested the Board consider a two-stage approach, which combines making targeted improvements to IAS 32 in the short term while undertaking a more fundamental review of the classification principle as part of a longer-term project.[2] A few other respondents expressed a view that targeted improvement can include clarifying the existing logic in IAS 32, for example, settlement in a variable number of own shares is broadly equivalent to the concept of using own equity as 'currency units' for settling obligation.

17. In contrast to those who see value in having clear classification principles as described in paragraph 15–16 of this paper, a few respondents expressed a view that most of the challenges identified with IAS 32 are of such a nature that they can be addressed through targeted amendments to IAS 32. The issues that have arisen in practice relate rather to the application of the principles to features that are currently prevalent in financing agreements. Therefore, what is needed in these respondents' view, is clarity on and consistency with the application of the principles rather than new principles.

18. In relation to the areas the Board should target for more focussed improvements, most respondents supported improving disclosures based on the proposals in the DP. Other most commonly mentioned areas included the following:

    (a) Accounting for written put options on non-controlling interest;

    (b) Application of the fixed-for-fixed condition, especially the effects of anti-dilution provisions; and

    (c) Application of the contingent settlement provision requirements.

Fundamental review

19. Some respondents said that the Board should undertake a fundamental review of an approach to distinguishing liabilities from equity with the aim of achieving an

[2] It was noted that the next Agenda Consultation is a good opportunity for the Board to seek inputs from stakeholders on the need for such a longer-term project.

alignment with other IFRS Standards as well as the Conceptual Framework. Some respondents further supported this view by adding that a robust set of principles should not necessitate exceptions.

20. Many of those respondents who prefer a fundamental review expressed a view that there are only two reasonable approaches to address the challenges identified with the application of IAS 32—either a fundamental rethinking that result in the development of a comprehensive classification model or making narrow-scope amendments to IAS 32 focussing on resolving known application issues. Some of these respondents questioned whether it is appropriate or even achievable to set the project objective as 'articulating the classification principle with a clear rationale without fundamentally changing the existing outcomes of IAS 32' because in their view the principle should drive the outcomes and not the other way around. They found that the DP was seeking to form a rationale for confirming the existing classification requirements in IAS 32.

21. On the other hand, a few respondents who prefer a targeted improvement approach, supported the Board's approach of articulating classification principles without fundamentally changing the existing classification outcomes because it balances the need to address existing challenges while not causing unnecessary disruption to stakeholders who do not have challenges when applying IAS 32.

Principles-based solution

22. Many respondents said that it is important to have a principles-based solution and some of these respondents supported the Board proceeding with the preferred approach set out in the DP subject to some clarifications and/or modifications. Suggestions included the clarification of terminology used and a closer alignment of the terms used and/or the classification outcomes with those in accordance with IAS 32.

23. In contrast, some other respondents suggested classification principles that represent more significant modifications of the Board's preferred approach such as the amount feature excluding the obligation that only arises on liquidation, or approaches based primarily or solely on the timing feature (see Agenda Paper 5A for the June 2019 meeting).

Disclosure-only

24. A few respondents supported a disclosure-only project because in their view, IAS 32 works well for most financial instruments and do not present significant challenges.

25. A few respondents who support one of the other approaches also said that the Board should proceed with the disclosure proposals in the DP even if the Board decides not to change the classification approach.

What should be the project objective?

26. Some respondents highlighted what they view as an important objective of the FICE project. In their view, the Board's chosen approach should aim to achieve the following:

    (a) Resolve future interpretation issues on a timely basis;

    (b) Resolve previously unresolved issues submitted to the IFRS Interpretations Committee;

    (c) Promote consistent classification outcomes for contracts with the same or similar economic substance;

    (d) Limited classification changes compared to IAS 32;

    (e) Limited transition cost and the need for reassessment of existing classification outcomes; and

    (f) Provide more complete information about the terms of financial instruments that have features of both debt and equity.

Other comments

27. A few respondents highlighted that there are other more pressing matters for the Board to address as a matter of urgency, for example the project on IBOR reforms and that addressing the accounting implications of IBOR reforms should be prioritised over the FICE project, if necessary.

Questions for the Board

28. At a future Board meeting, the staff plan to present a project proposal to the Board, taking into account the Board's objective for the FICE project, the challenges identified with the current accounting principles and the feedback received. The staff will then ask the Board for a decision on the project direction and next steps. In view of this, the staff would like to ask the following questions.

Questions for the Board
Does the Board need any additional information or further research on particular topics before making its decision on the project direction? What would the Board find particularly useful in the project proposals to enable a decision to be made?