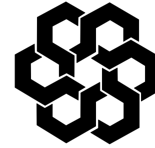

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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **23 July 2008, London**

Project: **Liabilities and Equity**

Subject: **Agenda Proposal (Agenda Paper 2A)**

INTRODUCTION

1. This paper discusses a proposal to add to the IASB's active agenda a project on the distinction between equity instruments and other financial instruments (non-equity instruments). The project (the liabilities and equity project) is currently on the IASB's research agenda.

2. This paper

   (a) summarises the background of the liabilities and equity project

   (b) discusses whether the project meets the IASB's agenda criteria

   (c) provides a staff recommendation

   (d) asks the IASB whether it wants to add the project to its active agenda

BACKGROUND OF THE LIABILITIES AND EQUITY PROJECT

Criticisms of IFRS requirements

3. The accounting requirements for financial instruments are often criticized. The IASB has been urged by many constituents to improve and simplify those requirements. The

liabilities and equity project is one of three projects on the IASB's research agenda that address those concerns. Specifically, the objective of this project is to improve the distinction between equity and non-equity instruments.

4. IAS 32 *Financial Instruments: Presentation* sets out today's requirements relevant to the distinction between equity and non-equity instruments. The criticisms of those requirements fall into two broad classes:

   (a) how the principles in IAS 32 should be applied and

   (b) whether application of those principles results in an appropriate distinction between equity instruments and non-equity instruments.

5. The principle in IAS 32 is straightforward: if a financial instrument does not meet the definition of a financial asset or a financial liability, it is classified as an equity instrument. However, the application of that principle can be problematic and some have asked how it should be applied in specific situations. For example, a contract to exchange a financial asset for an entity's own equity instruments is classified as equity if both the amount of the financial asset and the number of equity instruments are fixed. This raises the question of what 'fixed' means.

6. The existence of a contractual obligation to deliver a financial asset overrides any other characteristics of a financial instrument for the purposes of classification. Some argue the application of that principle results in inappropriate classification of some financial instruments. For example, an entity may not have any financial instruments classified as equity because the entity issues only redeemable instruments.

7. Those two broad classes of criticisms are described in more detail in the Discussion Paper *Financial Instruments with Characteristics of Equity*.

Work performed in the project to date

8. As noted in paragraph 1 of this paper, the liabilities and equity project is on the IASB's research agenda. The project is included in the Memorandum of Understanding (MoU) *A Roadmap for Convergence between IFRSs and US GAAP–2006 to 2008*. One of the goals for 2008 set out in the MoU is 'to have issued one or more due process documents relating to a proposed standard' on the distinction between liabilities and equity.

9. The initial research stage of the project was led by the FASB. In November 2007 the FASB published a Preliminary Views document *Financial Instruments with Characteristics of Equity*. The PV document contains three approaches for determining

which instruments should be classified as equity instruments. The FASB's preliminary view is that one of the approaches (the basic ownership approach) is the appropriate method.

10. The IASB did not participate in the development of the FASB document, has not deliberated any of its conclusions, and does not have a preliminary view. In February 2008 the IASB issued a discussion paper, which contains an Invitation to Comment and the FASB Preliminary Views document.

11. The primary objective of the IASB's discussion paper is to determine whether the approaches contained in the FASB PV document are a suitable starting point for the IASB. The IASB discussion paper also asks whether there are alternative approaches to improve and simplify IAS 32.

12. In paragraph 7 of the discussion paper, the IASB noted that the Board will consider a proposal to add the project to its active agenda. The IASB also noted that if the project is added, the IASB and the FASB (the boards) intend to undertake it jointly and will consider the responses to the IASB discussion paper and the FASB PV document as the boards develop a common standard.

13. In their joint meeting in April 2008, the boards affirmed that the liabilities and equity project is a high priority.

IASB'S AGENDA CRITERIA

14. The IASB due process handbook sets out five criteria to be considered in deciding whether to add an item to the agenda.

Criterion 1: The relevance to users of the information involved and the reliability of information that could be provided

15. Criterion 1 considers whether the project addresses the needs of users across different jurisdictions. The criterion considers the following factors:

    (a) international relevance

    (b) pervasiveness

    (c) urgency

    (d) consequences of not adding the project to the agenda

16. Distinguishing between equity and non-equity instruments has widespread relevance. The issue affects various types of reporting entities (for example, for-profit entities, partnerships, and cooperatives) in many jurisdictions. Reporting entities continually issue instruments with characteristics of both equity and non-equity.

17. Moreover, distinguishing between equity and non-equity instruments has an effect on both the statement of financial position and the statement of comprehensive income. First, that determination establishes how the instrument is classified. Second, it affects whether the instrument is remeasured and how distributions to instrument holders are recorded.

18. As noted in paragraphs 3-7 of this paper, constituents have urged the IASB to improve the accounting requirements for financial instruments and have criticised the requirements in IAS 32. The IASB recently responded to some of those criticisms by amending IAS 32 to address issues related to puttable instruments and instruments that contain an obligation on liquidation. Moreover, the International Financial Reporting Interpretations Committee (IFRIC) has addressed other issues (for example, IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments*).

19. If the IASB does not add the liabilities and equity project to its active agenda, practice problems will persist. The Board and IFRIC will continue to receive requests to clarify and interpret the requirements in IAS 32. Staff resources will be necessary to address those requests.

20. The staff thinks the liabilities and equity project meets Criterion 1. The distinction between equity and non-equity is internationally relevant. Moreover, practice problems related to the requirements in IAS 32 are pervasive and urgent.

Criterion 2: Existing guidance available

21. Criterion 2 considers whether the project will address an area on which existing guidance is insufficient.

22. As previously noted in this paper, IAS 32 provides the relevant requirements and constituents have told the IASB that those requirements are difficult to apply and result in inappropriate classification of some financial instruments. Although both the IASB and IFRIC have 'patched' the requirements in IAS 32, practice problems continue to arise.

23. In 2003 the IASB revised IAS 32. The main objective of that project was a limited revision to provide additional guidance on selected matters. The IASB did not reconsider

the fundamental approach in IAS 32. In the Basis for Conclusion, the Board noted that there are practice issues that were not within the scope of the improvements project but that would be addressed in the future. For example, the IASB did not debate whether an obligation can be established implicitly rather than explicitly. Rather the IASB stated that that issue would be considered by the Board in its major project on liabilities and equity.

24. Moreover, members of the IASB Board and staff have spoken with users of financial statements (for example, buy and sell side analysts) about the recently-published discussion paper. In general, users noted that the current distinction between equity and non-equity instruments is difficult to understand and strongly supported improved guidance.

25. Furthermore, the requirements in IAS 32 are different from the requirements in US GAAP. Therefore, there is a lack of comparability in financial reporting.

26. The staff thinks the liabilities and equity project meets Criterion 2. There are criticisms and practice problems related to the current requirements. Moreover, requirements in IFRS and US GAAP are different.

Criterion 3: The possibility of increasing convergence

27. Criterion 3 considers whether undertaking the project would increase the possibility of achieving convergence of accounting standards in different jurisdictions.

28. As noted in paragraph 8, the liabilities and equity project is included in the MoU between the IASB and FASB. If this project is added to the agenda, it will be undertaken jointly. The boards' goal is to issue an improved and converged standard.

29. The staff thinks the liabilities and equity project meets Criterion 3. IFRS requirements are different from US GAAP. Therefore, there is a significant opportunity to increase convergence with US GAAP.

Criterion 4: The quality of the standards to be developed

30. Criterion 4 considers the qualitative aspects of the standards that are proposed to be developed. This criterion considers the following factors:

    (a) availability of alternative solutions

    (b) cost/benefit considerations

    (c) feasibility

31. The FASB PV document explores three approaches for distinguishing equity instruments from other financial instruments (basic ownership, ownership-settlement, and reassessed expected outcomes). Moreover, the PV notes three additional approaches that the FASB considered but decided not explore further in the PV document (claims, mezzanine, and loss-absorption).

32. While the FASB reached a preliminary view that the basic ownership approach is the preferred approach, the IASB has not deliberated the approaches and does not have a preliminary view. If the IASB decides to add the liabilities and equity project to its agenda, the Board will need to decide which approach to pursue. The envisaged outcome of the liabilities and equity project is an improved distinction between equity and non-equity instruments. That would have many benefits. Preparers would be better able to understand and consistently apply the requirements. Users would be able to better comprehend the fundamental characteristics of equity instruments. That is, users would be able to easily understand how and where the 'line' is drawn between equity and non-equity instruments, which will enable them to better evaluate the entity's performance and financial condition. Moreover, structuring opportunities to achieve a desired accounting treatment would be minimised.

33. The costs of implementing the change will depend on which approach the IASB decides to pursue. For example, the staff thinks that the basic ownership approach would be relatively simple to understand and implement. The ownership-settlement approach would be more difficult and costly because that approach is more complex (for example, more instruments are split into components).

34. The staff prepared a proposed project plan and, at the June IASB meeting, the Board generally agreed with the staff's proposal. Based on that plan, the staff thinks that it is feasible to develop a technically sound solution within a reasonable time period. The liabilities and equity project does not have to await the completion of other projects. While there is an overlap between this project and the IASB's project on the conceptual framework, the staff does not think that it is necessary (or prudent) to delay the liabilities and equity project until the completion of the conceptual framework project. The staff thinks that there are practice problems that need to be resolved at a standards-level before the completion of the conceptual framework project. Also, there is a link between this project and the IASB's project on financial statement presentation. While the staff does not think that it is necessary to delay the liabilities and equity project until the completion of the financial statement presentation project, the two project teams will need to remain apprised of each other's discussions and progress.

35. The staff thinks that the liabilities and equity project meets Criterion 4. It is possible for the IASB to develop an improved distinction between equity and non-equity instruments in a reasonable amount of time.

Criterion 5: Resource constraints

36. Criterion 5 considers whether there are sufficient resources to undertake the project. The criterion considers the following factors:

    (a) availability of expertise outside the IASB

    (b) amount of additional research required

    (c) availability of resources

37. Because the FASB led the initial stage of this project, the FASB staff has expertise related to the proposed approaches. Because it is envisioned that the liabilities and equity project will be a joint project between the IASB and the FASB, that expertise will continue to be utilised in this project.

38. Additionally, the IASB recently issued amendments to IAS 32 related to puttable instruments and instruments with obligations arising on liquidation. Those amendments address contentious issues related to the distinction between equity and non-equity instruments (for example, whether an instrument with a redemption feature should be classified as equity). Those issues will be considered in the liabilities and equity project. Therefore, the expertise developed by the staff and the IASB during the amendments project will be utilised in the liabilities and equity project.

39. Furthermore, the staff will solicit input and expertise on an as-needed basis from the IASB Financial Instruments Working Group (FIWG) and the FASB's resource group.

40. During the development of the FASB PV and the IASB discussion paper, a significant amount of research was performed by the FASB and IASB staff. That research includes (a) development of alternative approaches to distinguish equity and non-equity instruments, (b) an analysis of criticisms of current requirements and (c) a comparison of the proposed approaches and current requirements. The staff thinks that this research and analysis is sufficient to form the basis for beginning the project.

41. Both the IASB and the FASB have assigned resources to the liabilities and equity project. Those staff members have expertise related to financial instruments, are familiar with

practice problems related to the current requirements, and have sufficient background knowledge of the project.

42. The staff thinks the liabilities and equity project meets Criterion 5. There are sufficient resources to undertake the project.

STAFF RECOMMENDATION

43. The staff believes that the liabilities and equity project meets the agenda criteria. Therefore, the staff recommends that the project is moved from the research agenda to the IASB's active agenda.

INPUT FROM THE STANDARDS ADVISORY COUNCIL (SAC)

44. In June, the staff asked the SAC for input on whether the Board should add the liabilities and equity project to its active agenda. The SAC agreed with the staff recommendation and voted that the project should be moved from the research agenda to the active agenda.

45. However, SAC members also expressed some concerns and observations. The staff has summarized some of the members' comments below.

46. Several SAC members asked whether the liabilities and equity project is a priority in the context of the Board's overall agenda. They noted that the Board's current work plan is large and challenging. As an alternative, members asked whether IAS 32 could be 'patched.' Other members responded that patching IAS 32 inevitably would result in more rules-based exceptions to IAS 32. That is not consistent with the Board's objective to develop improved and principles-based guidance.

47. Some SAC members were concerned about the overlap between this project and Board's project on the conceptual framework. Members noted that it might be better to defer the liabilities and equity project until the completion of the conceptual framework project. Board members and staff acknowledged that it would be challenging to address concepts-level and standards-level issues concurrently; however, there are practice problems that need to be resolved before the conceptual framework project is complete.

48. Some SAC members recommended that the Board consider approaches other than the three in the FASB PV document. Board members agreed and noted that the discussion paper specifically asks whether there are alternative approaches. Some SAC members pointed out that it may be difficult for the boards to agree on which approach to pursue because the FASB already has a preliminary view.

49. Some SAC members asked whether classification for accounting purposes should be the same as classification for regulatory capital or legal purposes. Board members responded that it is reasonable to expect some similarities among the classifications. However, the objective of financial reporting is different than the objective of regulatory reporting. Furthermore, it would be impossible to develop an accounting principle that is consistent with the regulatory and legal requirements in all jurisdictions. Some SAC members who are banking, insurance, or similar financial regulators agreed with these comments.

50. Despite their concerns, the SAC agreed that the liabilities and equity project is important and recommended that the Board add the project to its active agenda.

QUESTION FOR THE BOARD

51. **Does the Board agree that the liabilities and equity project should be added to the active agenda? If not, why?**