STAFF PAPER

April 2014

IASB Meeting

Project	**Financial Instruments with Characteristics of Equity research project**
Paper topic	Project plan

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Introduction

1. At this meeting, we will introduce the Financial Instruments with Characteristics of Equity research project. This paper sets out a preliminary project plan for the IASB's information. This paper does not include any questions for the IASB.

2. This plan sets out the following:

   (a) Background (paragraphs 3–7)

   (b) Preliminary objective of the research project (paragraphs 8–10)

   (c) Scope of the research project and interactions with other projects (paragraphs 11–17)

   (d) Challenges (paragraphs 18–20)

   (e) Outreach (paragraphs 21–22)

   (f) Due process (paragraphs 23–25)

   (g) Appendix A—Timetable

Background

3. The *Conceptual Framework* defines liabilities and equity (two of the elements of financial statements). IAS 32 *Financial Instruments: Presentation* is the Standard

that applies those definitions and that preparers use to determine whether a particular financial instrument should be classified as a liability or equity.

4. The IASB had a previous project to address liability and equity issues arising from IAS 32. That project resulted in the publication of the discussion paper *Financial Instruments with Characteristics of Equity* in February 2008 and was subsequently suspended in October 2010 when the IASB reassessed its agenda. At that time, the Board noted that a decision on if, and how, it would ultimately proceed with the project would depend on the outcome of the ongoing deliberations about its future work plan.

5. In the Agenda Consultation Feedback Statement published in December 2012, the IASB:

   (a) identified the Financial Instruments with Characteristics of Equity project as one of its priority research projects on the basis of the views that it received.

   (b) noted that any consideration of the distinction between liabilities and equity needed to be undertaken in conjunction with the Conceptual Framework work on elements of financial statements. The research project would focus on identifying financial instruments that are difficult to classify under the current requirements, or for which preparers or users question the classification. These instruments would provide test cases for the staff developing the elements chapter of the Conceptual Framework.

6. Therefore, this project interacts with the IASB's Conceptual Framework project and follows on from the preliminary views in the Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* (the Conceptual Framework DP) and the feedback received on those views.

7. In addition to the above, we think that investigating potential improvements to the standards-level distinction between liabilities and equity at the same time as the Conceptual Framework project is important and appropriate because:

   (a) Some respondents (predominantly users and standard-setters) suggested that a more detailed exploration of the distinction between liabilities and equity was required before the Conceptual Framework is finalised.

(b) The IASB has long acknowledged the differences between IFRS 2 *Share-based Payments* and IAS 32 *Financial Instruments: Presentation*. In the Basis for Conclusions on IFRS 2, the IASB stated that before deciding whether and how those differences should be eliminated, it is necessary to address the issue as part of a fundamental review of the definitions of liabilities and equity in the Conceptual Framework.

(c) There have been an increasing number of issues (some of them remaining unresolved) submitted to the IFRS Interpretations Committee (IC). These issues highlight some of the inconsistencies, complexity and counterintuitive results when classifying items as liabilities or equity.

Preliminary objective of the research project

8. As noted in the Due Process Handbook of the IASB, the purpose of the IASB's research programme is to analyse possible financial reporting problems by collecting evidence on the nature and extent of the perceived shortcoming and assessing potential ways to improve financial reporting or to remedy a deficiency. This analysis will help the IASB decide whether it should add to its standard-setting programme a project to develop a proposal for a new Standard or to amend or replace a Standard.

9. In the short-term, and consistent with the IASB's views expressed in the Feedback Statement on its Agenda Consultation, the objective of the research project will be to identify the problems related to the distinction between liabilities and equity in current Standards to inform the IASB's discussion of the elements of financial statements in the Conceptual Framework project.

10. In the medium to long-term, this project will investigate whether to developing a new Standard or amending existing Standards to address the problems identified and whether to make changes to the Conceptual Framework.

Scope of the research project and interactions with other projects

11. The distinction between liabilities and equity plays a fundamental role in many aspects of accounting—the effects are pervasive in IFRS. These include, but are not limited to:

    (a) Various conceptual framework topics, such as element definitions, going concern, reporting entity, performance, measurement and disclosure.

    (b) Instruments within the scope of IAS 32 and supporting interpretations (IFRS 9 *Financial Instruments*, IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments*, IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments*).

    (c) Standards instruments and transactions beyond the scope of IAS 32 (IFRS 2 *Share-based Payments* and IFRIC 17 *Distributions of Non-cash Assets to Owners*).

    (d) Performance reporting and presentation (IAS 1 *Presentation of Financial Statements* and IAS 33 *Earnings per Share*)—eg the definitions of income and expense, and therefore profit or loss and other comprehensive income, depend on the liability and equity distinction. Reporting diluted earnings per share has been one way of presenting dilution of return to owners of common shares.

    (e) Business combinations and consolidations (IFRS 3 *Business Combinations* and IFRS 10 *Consolidations*)—eg classification of non-controlling interests, changes in intra-group holdings and group capital structure, mandatory tender offers etc.

    (f) Investments in associates and equity accounting (IAS 28 *Investments in Associates and Joint Ventures*)

12. The IASB has not yet discussed the scope of the project. The scope of the previous project focused on financial instruments within the scope of IAS 32. At this stage, the main focus of our investigations in this research project will continue to be those financial instruments, however we will consider some of the other interactions where

relevant. Depending on the outcome of the Conceptual Framework project, the IASB might expand the scope to include other areas such as parts of IFRS 2.

13. The rest of this section discusses:

    (a) the interaction with the Conceptual Framework project; and

    (b) potential interactions with other issues on the IASB's and the IC's agendas.

Interaction with the Conceptual Framework project

14. The IASB's approach to the equity section in the forthcoming Conceptual Framework Exposure Draft is discussed in Agenda Paper 10B. Specific topics that will be discussed in that project and are relevant to this research project include:

    (a) Elements – including whether the distinction between liabilities and equity should be based on the definition of a liability, and amendments to that definition to address the issues identified in the Discussion Paper and the concerns raised by respondents to the Discussion Paper.

    (b) In addition, the Conceptual Framework should neither require nor preclude the following:

        (i) Additional classes within equity.

        (ii) Measurement, recognition and presentation of changes in individual classes within equity.

        (iii) Disclosure requirements for equity instruments.

Other issues

15. There are a number of application issues in progress either at the Interpretations Committee or the IASB that relate to the distinction between liabilities and equity. The IASB could include a number of these issues in the scope of this project at a later date. We will bring an analysis of these issues to the IASB at a future meeting.

16. These issues include the following related to IAS 32:

    (a) Accounting for put options written on non-controlling interests and mandatory tender offers (last discussed by the IASB in late 2013). The

IASB tentatively decided to re-consider the requirements in paragraph 23 of IAS 32, including whether all or particular put options and forward contracts written on an entity's own equity (including mandatory tender offers) should be measured on a net basis at fair value. This issue has been identified as a good test case for the Conceptual Framework discussion, and hence will be investigated as part of this research project. However, part of the mandatory tender offer issue relates to business combinations and might better be addressed in isolation, or as part of the Post-Implementation review of IFRS 3. We will bring a paper discussing this issue to a future meeting.

(b) Classification by the issuer of a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event. The IC decided not to add this issue to its agenda in January 2014. It noted that the scope of the issues raised in the submission is too broad for it to address in an efficient manner. The IASB has not discussed this issue specifically.

(c) An issuer's accounting for a financial instrument that is mandatorily convertible into a variable number of shares subject to a cap and a floor. The IC issued a tentative agenda decision with comment period ending mid April 2014.

17. In addition, the following issues that the IC referred to the IASB with a recommendation for a narrow scope amendment to IFRS 2 may be relevant:

(a) Accounting for share-based payment transactions in which the manner of settlement is contingent on a future event that is outside the control of both the entity and the counterparty. The IASB last discussed this issue in February 2014. The IASB asked the staff to perform more analysis.

(b) Modification of a share-based payment from cash-settled to equity settled. The IASB last discussed this issue in February 2014. The IASB asked the staff to perform more analysis.

Challenges

18. Improving the distinction between liabilities and equity requires an understanding of subtle distinctions between very complex instruments, the resulting economic effects and the accounting outcomes and constraints. In the previous project, the IASB was unable to reach a consensus on the distinction between liabilities and equity. Similar attempts to achieve a consensus in other fields, such as regulatory and tax law, have also failed.

19. There are a number of reasons why a Standards-level project could fail to address the problem identified, and part of the objective of this research project will be to identify and better understand those challenges. This will inform the IASB when it assesses whether to add a project to its standard-setting programme, and the scope and structure of any such project.

20. A preliminary analysis of the challenges that such a project will face might include that:

    (a) the universe of claims is continuous, not discrete. Splitting this continuous set into two discrete segments polarises the accounting outcomes (in both the statement of financial position and the statement(s) of profit or loss and other comprehensive income).

    (b) the existing binary distinction between claims has been in place for a long time. That history might inform peoples' views of the desired accounting outcomes.

    (c) the effects of the distinction might go beyond financial reporting. We will need to be aware of links with areas that interact with the reporting environment, such as regulatory capital requirements.

    (d) it is very easy to replicate similar economic outcomes in different ways using financial instruments (structuring), therefore consistency is vital but difficult to achieve because of the complexity of those instruments.

Outreach

21. At this stage, most of the active outreach will be integrated with the Conceptual Framework project. The main focus of that outreach will be to understand the difficulties users have encountered related to this issue and to understand what users need to overcome those difficulties.

22. We will also maintain a project page on the IFRS website for this research project and an alert category to keep interested parties informed about any developments.

Due process considerations

23. The first step in developing a new financial reporting requirement is to assess and define the problem within the existing reporting practice.

24. The main output of this research project is expected to be a Discussion Paper. Such a Discussion Paper might include a comprehensive overview of the issue, possible approaches to addressing the issue, the preliminary views of its authors or the IASB and an invitation to comment. We intend to discuss all matters to be included in a potential Discussion Paper in public meetings of the IASB.

25. The Discussion Paper will be designed to elicit from interested parties comments that can help the IASB decide whether to add a project to its standard-setting programme. Comments on the Discussion Paper will us in developing a project proposal and an assessment against the project criteria.

26. Project stage:

Project	Current status	Next due process milestone
Conceptual framework project	Post-DP deliberations	Publish ED late 2014
Financial Instruments with Characteristics of Equity research project	Research Programme	Publish a Discussion Paper to accompany the Conceptual Framework ED in late 2014.

Appendix A—Timetable—Short-term plan

Project	April	May	June
Conceptual framework project	Discuss plan for deliberating the liabilities and equity topic in the Conceptual Framework (Agenda Paper 10B)	Discuss matters identified in April, including: Definitions of liability and equity. Confirm that the Conceptual Framework should not require or preclude subclasses within equity and recognition, measurement, presentation and disclosure requirements for equity instruments.	
Financial Instruments with Characteristics of Equity research project	Discuss this plan with the Board	Discuss issues identified in existing Standards. Discuss background of predecessor projects.	Preliminary analysis of characteristics and economics. Begin investigating standards level issues following IASB tentative decisions on Conceptual Framework
Other related issues		NCI Puts and MTOs: Divide issues between this project and IFRS 3 PIR	