STAFF PAPER

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Board meeting

Project	**Financial Instruments with Characteristics of Equity research project**		
Paper topic	Scope and next steps		
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Introduction

1. The purpose of this session is to discuss the scope and next steps of the Financial Instruments with Characteristics of Equity research project (the research project).

2. I recommend that the IASB pursue the following two overlapping streams of work in the research project:

   (a) **Classification Stream**–Improvements to the classification of liabilities and equity in IAS 32 *Financial Instruments: Presentation*, including potential amendments to the definitions of liabilities and equity in the Conceptual Framework; and

   (b) **Presentation and Disclosure Stream**– Improvements to the presentation and disclosure requirements for some financial instruments with characteristics of equity[1] in IAS 32, irrespective of whether they are classified as liabilities or equity.

3. The rest of this paper is structured as follows:

   (a) What is the current status, and scope, of the research project?

   (b) How will this project interact with the Conceptual Framework project?

[1] In this paper, the term financial instruments with characteristics of equity includes financial instruments that are settled by delivering the reporting entity's own equity instruments, or that are settled by transferring economic resources equal to the value of part or all of the reporting entity's own equity instruments.

(c) What is the revised objective of the research project?

(d) How should the IASB proceed with the research project?

(e) Appendix A-Feedback from ASAF

What is the current status, and scope, of the research project?

4. To date, the main focus of the research project has been to inform the IASB's discussion of the elements of financial statements in the *Conceptual Framework* project. The IASB had not made a decision regarding the scope of the research project, pending the outcome of the *Conceptual Framework* project.

5. At its April 2014 meeting, the IASB tentatively decided that the *Conceptual Framework*:

   (a) should continue to make a binary distinction between liabilities and equity and build on the feedback received on the discussion paper *A review of the Conceptual Framework for Financial Reporting* (the Discussion Paper) to develop definitions of a liability and of equity; and

   (b) should not provide further detailed guidance on how to distinguish liabilities from equity claims.

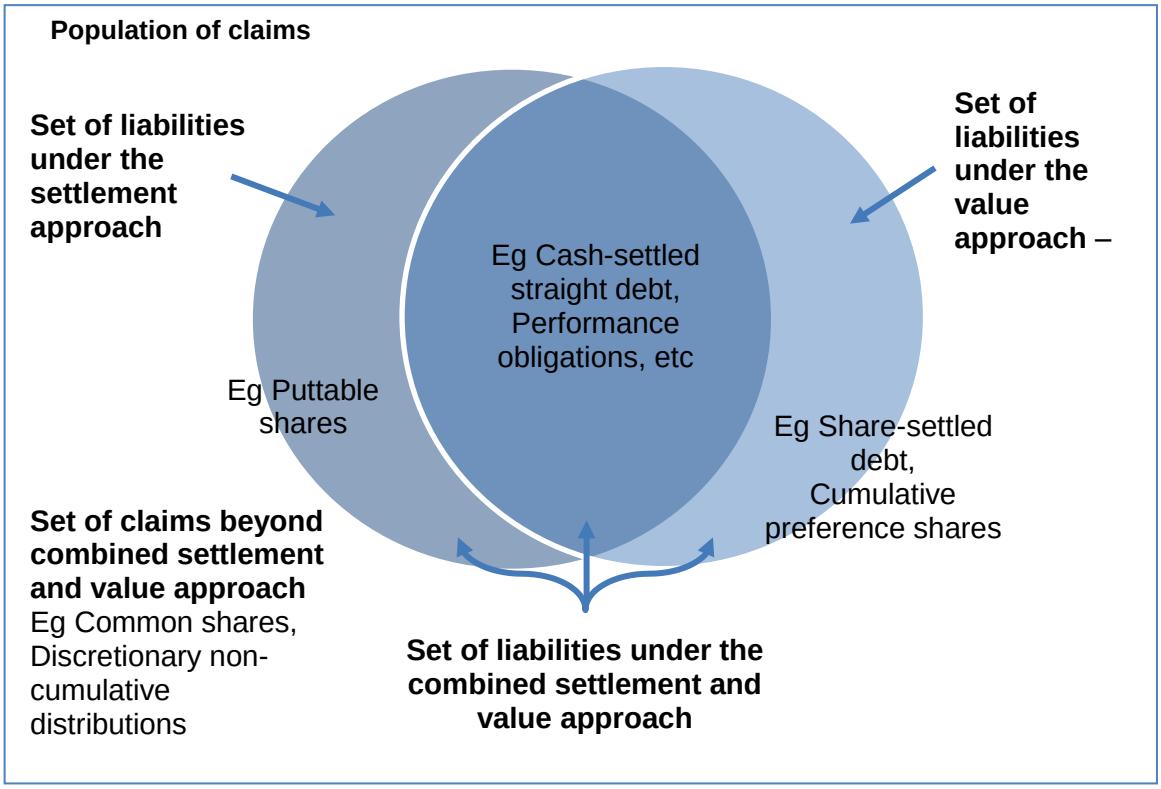
6. On the basis of the feedback received on the Discussion Paper, and Chapter 1 of the existing Conceptual Framework, we developed four possible approaches to distinguishing between liabilities and equity. The IASB discussed those approaches in an education session in June 2014.

7. In September 2014, the IASB considered possible changes to the definition of a liability being developed for inclusion in the Conceptual Framework Exposure Draft that would implement one of those approaches: the combined settlement and value approach. However, at that meeting the IASB tentatively decided not to propose changes to the definitions of a liability and of equity at this time. As a consequence, the changes to the definition of a liability and related concepts being proposed in the Exposure Draft will be designed mainly to help determine when a liability comes into existence —leaving for future work the question of how to distinguish between liability and equity claims.

8. The Basis for Conclusions on the Conceptual Framework Exposure Draft will explain that the IASB will further explore how to distinguish liabilities from equity claims[2] in its research project on Financial Instruments with Characteristics of Equity. The Basis will also explain that one possible outcome of the research is a recommendation to propose an amendment to the Conceptual Framework in relation to distinguishing between liabilities and equity. Whether or how the Conceptual Framework might be amended is a matter of conjecture pending the outcome of the research.

How will the scope of this project interact with the Conceptual Framework project?

9. The diagram below illustrates the total population of claims against an entity, and illustrates the interaction between three of approaches to distinguishing between liabilities and equity that the IASB has been exploring in its *Conceptual Framework* project.[3]



[2] This paper refers to liabilities and equity collectively as 'claims'.

[3] The three approaches illustrated in the diagram are all based on a positive definition of a liability. The fourth approach (the narrow equity approach), which is not illustrated in the diagram, would classify the most residual claim as equity regardless of any of its other features.

10. The circles divide the total population of claims into four segments:

    (a) The set of claims that would be classified as liabilities under all approaches (the intersection between the two circles in the diagram below). This set would include items that have no equity-like characteristics and will be settled by transferring economic resources. They include items such as cash-settled straight debt, performance obligations and stand-ready obligations;

    (b) The set of claims that would be classified as liabilities under the settlement approach but not the value approach. This set would include items such as obligations to transfer economic resources equal to the value of an entity's equity instruments (eg puttable shares).

    (c) The set of claims that would be classified as liabilities under the value approach but not the settlement approach. This set would include items such as some obligations to deliver a variable number an entity's equity instruments equal to some specified value (eg share-settled straight debt).

    (d) The set of claims that would not be classified as liabilities under either the settlement or the value approach. This set would include items such as common shares and non-cumulative discretionary preference shares. Some of these claims might be classified as liabilities under the narrow equity approach.

11. We refer to the claims in paragraphs 10(b), 10(c) are 10(d) as 'financial instruments with characteristics of equity'.

12. The Conceptual Framework Exposure Draft will include the tentative definition of liability and the existing definition of equity. The tentative definition of a liability is consistent with the settlement approach, however, the consequences of the tentative decision in paragraph 7 are that the Exposure Draft:

    (a) will discuss the tentative definition of a liability and its role in identifying which types of claim should be recognised as a liability—in other words, the discussion will focus on the application of the tentative definition of a liability in identifying whether an entity already has an obligation to

transfer economic resources of the entity, especially if the obligation is uncertain or conditional;[4] but

(b) will not discuss the role of the definitions of a liability and of equity in distinguishing liabilities from equity claims—in other words, there will be no discussion of the application of the tentative definition of a liability to the classification of financial instruments with characteristics of equity.[5]

13. The distinction between the issues in 12(a) and 12(b) above is subtle but important. This will have to be communicated clearly and carefully in the Exposure Draft, given that the tentative definition of a liability does include some proposed changes to the existing definition and associated guidance.

14. The Exposure Draft will also include the tentative decision that profit or loss is the primary source of information about an entity's performance for the period. Given that the distinction between liabilities and equity determines which changes in an entity's claims meet the definitions of income and expense, there will be an interaction between the IASB's tentative decision on profit or loss, and its continuing discussion of the distinction between liabilities and equity in this research project.

15. The IASB will have to consider, in the light of its tentative decision about profit or loss, the following implications of the classification of claims as liabilities and equity:

(a) that changes in claims classified as equity will be recognised **outside** profit or loss and other comprehensive income, implying that changes in the value of such claims are not considered to be part of the primary source of information about an entity's performance for the period; and

(b) that changes in claims classified as liabilities will be recognised **within** profit or loss and other comprehensive income, and thus will be candidates for inclusion in profit or loss if they are considered to be part of the primary source of information about the entity's performance for the period.

16. The Exposure Draft will need to communicate those implications.

[4] In other words, the discussion will focus on the application of the tentative definition of a liability to the identification of uncertain and conditional obligations to transfer economic resources of the entity.

[5] There will also be no discussion of standards-level topics such as derivatives on own equity instruments, compound instruments and measurement of equity instruments.

What is the revised objective of the research project?

17. 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 consider adding to its standard-setting programme a project to develop a proposal for a new Standard or to amend or replace a Standard.

18. We started with the initial objective of identifying 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. We would have then investigated the standards level consequences of the IASB proposals in the *Conceptual Framework* in the research project. However, given the IASB's tentative decision in September 2014, the IASB will now have to continue its discussion of the *Conceptual Framework* definitions of a liability and of equity in this research project.

19. We have previously stated that investigating potential improvements to IAS 32 is required 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. The IASB has also previously stated its intention to consider the standards-level issues in parallel with the *Conceptual Framework*.

    (b) The IASB has acknowledged the differences between IFRS 2 *Share-based Payments* and IAS 32 in the Basis for Conclusions in IFRS 2. This inconsistency reduces comparability and creates opportunities for structuring.

    (c) There have been an increasing number of issues (some of them remaining unresolved) submitted to the IFRS Interpretations Committee. These issues include:

(i) Classification of a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event.

(ii) Put options written on non-controlling interests.

(iii) Mandatory purchases of non-controlling interests in business combinations.

(iv) Derecognition and reclassification on changes in circumstances.

20. We have also previously stated that we do not think that the objective of this project is to investigate potential improvements to IFRS 2. However, changes to the definitions in the *Conceptual Framework* may also have implications for future revisions to IFRS 2. Therefore, we think that this project should continue to focus on IAS 32; however we will consider the implications of any changes to the *Conceptual Framework* definitions for other standards, such as IFRS 2.

How should the IASB proceed with the research project?

21. At its September 2014 meeting, we presented the Accounting Standards Advisory Forum (ASAF) with a paper outlining two broad alternatives that the IASB could consider in proceeding with the project:

(a) A fundamental review of IAS 32; or

(b) Maintenance of IAS 32, together with improvements to presentation and disclosure requirements.

22. A summary of comments from ASAF members is in Appendix A.

23. What we presented to ASAF was in line with our original objective which has now changed as noted in paragraph 18.

24. The tentative decision in September 2014 implies that the research project can no longer be limited to maintenance of IAS 32. This is because of the existing differences between the definitions in the *Conceptual Framework* and those in IAS 32, and the number of questions being raised in the application of IAS 32. We think that the IASB will need to consider as part of this project whether the problems

identified should be addressed by changes to the existing definitions in IAS 32, changes to the definitions in the *Conceptual Framework*, or changes to both.

25. Furthermore, a comprehensive review of the requirements in IAS 32, based on sound concepts, will avoid introducing inconsistencies and exceptions through narrow-scope amendments. The IASB has undertaken narrow-scope amendments in the past, such as the exceptions for puttable instruments and for foreign currency rights issues. These exceptions introduced inconsistencies and made IAS 32 more complex and difficult to apply.

26. However, in the predecessor project, the IASB was unable to reach a consensus on a distinction between liabilities and equity that would have been an improvement to IAS 32. We have not found much evidence that the classification outcomes of IAS 32 need to be fundamentally reconsidered. Although some submissions to the Interpretations Committee have questioned the conceptual classification of some instruments, most submissions to the Interpretations Committee are about difficulties of applying the current requirements to complex financial instruments (as would be expected).

27. Furthermore, if feedback from users is any indicator, they would prefer simplifying the requirements by moving towards a narrower definition of equity. However this feedback may be partly a response to the current lack of disclosure regarding items classified as equity.

28. In addition, classification may not be the only solution to the problems identified, nor would any change in classification be a complete solution. Therefore, we think that this research project should continue the approach that the IASB began in its *Conceptual Framework* project; that of identifying:

    (a) what information is best provided using the liability/equity distinction; and

    (b) what information is best provided through disclosure, presentation and other means (such as earnings-per-share).

29. Consistently with the above, I recommend that the IASB should pursue the following two overlapping streams of work in the research project:

(a) **Classification Stream**–Improvements to the classification of liabilities and equity in IAS 32, including potential amendments to the definitions of liabilities and equity in the *Conceptual Framework*; and

(b) **Presentation and Disclosure Stream**– Improvements to the presentation and disclosure requirements for financial instruments with characteristics of equity in IAS 32, irrespective of whether they are classified as liabilities or equity.

30. I think that focusing on the two streams of work above, and exploring ways that information could be provided by some combination of classification, presentation and disclosure, will increase the project's chances of addressing the problems identified.

Question 1
Does the IASB agree that the research project should explore both: (a) Improvements to the classification of liabilities and equity in IAS 32, including potential amendments to the definitions of liabilities and equity in the *Conceptual Framework*; and (b) Improvements to the presentation and disclosure requirements for financial instruments with the characteristics of equity in IAS 32, irrespective of whether they are classified as liabilities or equity?

Classification Stream

31. The first stream will continue the IASB's discussion of the approaches developed for the distinction between liabilities and equity in the *Conceptual Framework* project, and will expand that work to discuss standards-level issues such as:

(a) Derivatives on own equity; and

(b) Issued compound instruments.

32. We envisage the next steps of this work stream will include the following topics:

(a) Develop further the approaches already explored and decide which approaches to include in a Discussion Paper.

(b) Discuss requirements for derivatives on own equity, including:

(i) Derivatives that may or must result in issuing own equity: forwards to issue own equity, written calls and purchased puts on own equity.

(ii) Derivatives that may or must result in buying back own equity: forwards to purchase own equity, written puts and purchased calls on own equity.

(c) Discuss requirements for unit of account, including:

(i) Bifurcation of issued compound instruments.

(ii) Initial measurement of components of compound instruments.

(d) Discuss requirements for interest, dividends, losses and gains.

Question 2
Does the IASB agree that the Classification Stream should explore the above classification issues? Should any topics be added or removed?

Presentation and Disclosure Stream

33. The second stream will focus on improving presentation and disclosure requirements for financial instruments with characteristics of equity, irrespective of their classification as liabilities or equity.

34. There have been consistent calls from investors and other users to improve the presentation and disclosure of 'troublesome' instruments. Frequent requests include improvements to the depiction of potential dilution, for example through scenario analysis and/or through improvements to earnings-per-share. Many suggest that improvements to presentation and disclosure would be easier to achieve than changes in classification requirements, and could lay the groundwork for fundamental changes to the accounting for claims in the future. As we state earlier, we think that classification by itself may not be enough to address all aspects of the problem.

35. The IASB has stated in its *Conceptual Framework* project that other potential improvements could be explored in a future project to develop or amend IFRSs, including:

    (a) Improving the presentation of particular changes in the measurement of liabilities that have characteristics of equity (such as changes in the value of instruments puttable at the fair value of common shares).

    (b) Introducing additional classifications within liabilities, or within equity, to depict other characteristics of claims that would not be depicted through whatever distinction is made between liabilities and equity. This could include developing requirements for the presentation of different classes within equity (eg common shares, preference shares etc) or within equity (eg convertible and non-convertible) or of different categories within those classes (eg retained earnings, reserves, distributable reserves).

    (c) Introducing requirements for updating the carrying amount of some classes of equity instruments.

    (d) Improvements to the disclosure of the terms of different equity claims (such as different participation rights).

36. We envisage the next steps of this work stream to include the following topics for inclusion in the Discussion Paper:

    (a) For financial instruments classified as equity:

        (i) Discuss potential definitions of sub-classes and categories.

        (ii) Discuss requirements for changes in equity instruments, including the allocation of total comprehensive income to sub-classes of equity, dividends, issuance of new equity instruments and buy-backs.

        (iii) Discuss requirements for the presentation of changes in equity, including the statement of changes in equity.

        (iv) Discuss requirements for disclosure by the entity of the rights of holders of the entity's equity instruments.

(v) Discuss disclosure of potential dilution, including whether to include a review of earnings-per-share within the scope of this project.

(b) For financial instruments with characteristics of equity classified as liabilities (mostly focussing on share-settled debt, and shares puttable at fair value):

(i) Discuss potential definitions of sub-classes of liabilities;

(ii) Discuss presentation of changes in such liabilities.

Question 3
Does the IASB agree that the Presentation and Disclosure Stream should explore the above topics? Should any topics be added or removed?

Next milestone

37. The next due process milestone is expected to be the publication of a Discussion Paper, covering both work streams recommended above. The original plan was to publish the Discussion Paper to accompany the *Conceptual Framework* Exposure Draft. Given the September 2014 decision to continue discussing the Conceptual Framework definitions of a liability and of equity into the research project, we no longer think that a significant overlap in comment periods is necessary.

38. Nevertheless, we think that some overlap would be ideal, given the interactions with other aspects of the *Conceptual Framework* project.

39. The IASB expects to publish an Exposure Draft of the *Conceptual Framework* in the first quarter of 2015. Therefore, we would like to aim for a publication date in mid-2015.

Appendix A-What did ASAF think?

40. At its March 2014 meeting, some ASAF members suggested that further research work or a new Standard might be needed in some areas, including for the distinction between liabilities and equity. However, this should not hold up the completion of the *Conceptual Framework*. The IASB could, if necessary, revisit these sections of the *Conceptual Framework* once the research work or revised Standards have been completed.

41. At its September 2014 meeting, we presented the ASAF with a paper outlining two broad alternatives that the IASB could consider in proceeding with the project:

    (a) An fundamental review of IAS 32; or

    (b) Maintenance of IAS 32, together with improvements to presentation and disclosure requirements.

42. ASAF members generally agreed that this was an area that the IASB should explore, however there were different views regarding the urgency of the review.

43. Many ASAF members stated that, while a fundamental review of the requirements was necessary, the IASB should not necessarily start from an entirely blank sheet of paper. IAS 32 proved to be robust during the financial crisis, although new financial products, such as bonds that are contingently convertible into equity if a non-viability event occurs, were testing the requirements. A fundamental review is needed to provide a better foundation and should focus on identifying the objectives of the distinction between liabilities and equity.

44. Some ASAF members referred to EFRAG's recent discussion paper on the Classification of Claims. Both EFRAG and the FASB have current projects on the distinction between liabilities and equity on their respective work plans.

45. Some ASAF members cautioned the IASB against pursuing a narrow-scope project because of the risk of introducing further exceptions and inconsistencies.

46. Some ASAF members stated that it is important that the IASB consider the distinction between liabilities and equity from the perspectives of both financial position and financial performance.

47. One ASAF member asked for more clarity about the plan to revisit the *Conceptual Framework* definitions after performing the research. Another ASAF member stated that the decision to consider the liabilities and equity distinction further in the research project was not consistent with the decision to expose the tentative definitions in the exposure draft. Yet another thought that the *Conceptual Framework* project should take the lead and not follow the research project.

48. What we presented to ASAF was in the context of our original plans for the IASB to pursue an approach in the *Conceptual Framework* exposure draft and perform the standards level work in the research project. However given the decision in September to continue deliberating the *Conceptual Framework* definitions in the research project, the context has slightly changed.