STAFF PAPER

September 2014

ASAF Meeting

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

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Introduction

1. The purpose of this session is to receive the advice of ASAF members on the scope of the Financial Instruments with Characteristics of Equity research project (the research project). We plan to discuss the scope of the research project with the IASB at its October 2014 meeting. The IASB will be discussing the distinction between liabilities and equity in its Conceptual Framework project in September 2014. We will provide an oral update of any relevant decisions made at that meeting.

2. This paper outlines two broad alternatives that the IASB could consider for how to proceed with the Financial Instruments with Characteristics of Equity research project (the research project):

   (a) A fundamental review of IAS 32 *Financial Instruments: Presentation*; and

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

3. We would welcome ASAF members' views on:

   (a) Which of the above alternatives would they suggest the IASB pursue?

   (b) Why do they prefer this alternative?

(c) What are the risks they perceive to the timely and successful completion of the project if that alternative is pursued?

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

   (a) Background (paragraphs 6–16)

   (b) Why is this project on the IASB's research agenda? (paragraphs 17–20)

   (c) How does this project interact with the Conceptual Framework? (paragraphs 21–24)

   (d) What is the objective of the research project? (paragraphs 25–27)

   (e) What challenges will this project face? (paragraphs 28–31)

   (f) How should the IASB proceed with the research project? (paragraphs 32–43)

5. The appendices include the following:

   (a) Appendix A—Tentative decisions and staff recommendations in the Conceptual Framework project.

   (b) Appendix B—EFRAG's discussion paper.

   (c) Appendix C—Feedback from CMAC and GPF meeting.

Background

6. At its March 2014 meeting, some ASAF members suggested that that further research work or a new Standard might be needed in some areas, including for the distinction between liabilities and equity[1]. 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.

7. Some ASAF members suggested that the conceptual distinction between liabilities and equity would be best dealt with in a revised Standard; however, others suggested that the Conceptual Framework should address the issue.

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

8. The *Conceptual Framework* defines liabilities and equity (two of the elements of financial statements). IAS 32 *Financial Instruments: Presentation* is one of the IFRSs that applies those definitions and that preparers use to determine whether a particular financial instrument should be classified as a liability or equity. Other IFRSs, such as IFRS 2 *Share-based Payments,* also deal with similar issues. 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 will continue to be those financial instruments; however we will consider some of the other instruments where relevant.

9. Agenda Paper 7B provides a brief overview of the relevant requirements in IAS 32 and Agenda Paper 7C highlights some of the most common and significant concerns and criticisms of those requirements.

10. The IASB had a previous project (conducted with the FASB) 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 but was subsequently suspended in October 2010 when the IASB reassessed the priorities of projects on its agenda.

11. Agenda Paper 7D includes further background information regarding the IASB's previous work.

12. In addition to the previous work performed by the IASB, both EFRAG and the FASB have current projects on the distinction between liabilities and equity on their respective work plans.

13. EFRAG recently published a discussion paper *Classification of Claims* that is intended to assist the IASB in this project. EFRAG's discussion paper takes a broad look at the classification of claims in general and includes some wider questions than simply how best to distinguish between liabilities and equity.

14. EFRAG's discussion paper identifies a number of choices that must be made when classifying claims and the consequences of those choices.

15. Appendix B includes a précis of the choices identified by EFRAG and how the IASB's tentative decisions and staff recommendations map to those choices thus far.

16. We will monitor the responses to EFRAG's Discussion Paper as it explores many issues that are relevant to this project.

Why is this project on the IASB's research agenda?

17. In 2011, the IASB performed a consultation on its agenda priorities (the 2011 Agenda Consultation). Respondents to the 2011 Agenda Consultation indicated that improvements in the area of distinguishing liabilities from equity are required.

18. While some of those respondents did not indicate why the project was a high priority, other respondents noted the following:

    (a) The requirements in IAS 32 are highly complex, poorly understood and, when applied to some instruments that are common in some jurisdictions, lead to classifications that are criticised for not reflecting the economic substance of the transactions.

    (b) The principles in IAS 32 (eg determining whether a contractual obligation exists, applying the fixed-for-fixed criterion, and determining whether a contingent settlement provision exists) are problematic and difficult to apply.

    (c) IAS 32 has over the years seen piecemeal amendments that raise practical issues and divergence in practice.

    (d) IAS 32 is not robust enough to address the increasing complexity and sophistication of instruments being developed.

    (e) Developing an improved distinction between liabilities and equity would complete the IASB's comprehensive reconsideration of the accounting for financial instruments.

    (f) The IASB should consider the definition of equity in particular regulatory and legal frameworks (such as Basel).

19. Many respondents to the agenda consultation expressed the view that completing the project on the Conceptual Framework should be a top priority. Many of those respondents did not specifically discuss the interaction between the Conceptual

Framework project and a standards-level project. However, those that did comment on that interaction had differing views:

(a) A few stated that the primary issue in the research project (ie distinguishing equity instruments from non-equity instruments) could be integrated into the Conceptual Framework project. In other words, those respondents seemed to suggest that a separate FICE project would be unnecessary if the IASB developed clear and robust definitions of assets, liabilities, and equity in the Framework.

(b) Others expressed the view that the IASB must complete the Framework project before it reactivates (or begins) any standards-level project that relies on the concepts in the Conceptual Framework. (In contrast to the respondents described in (a), these respondents did not seem to suggest that the FICE project could be integrated into the Framework project. Rather they commented on the sequencing of the two projects.)

20. Others said that the Board needs to address urgently the practice problems related to IAS 32 (and, separately, complete the Conceptual Framework project).

How does this project interact with the Conceptual Framework?

21. 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 responses 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.

22. Therefore, this research 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* and the feedback received on those views.

23. Appendix A includes the IASB's tentative decisions to date on the Conceptual Framework project, and the staff recommendations for the IASB's September meeting. The IASB is considering four different approaches to distinguishing between liabilities and equity in that project. The IASB will be deciding on its preferred approach, and the consequences to the Conceptual Framework of pursuing its preferred approach, at its September 2014 meeting.

24. The IASB's decision on how to proceed with the research project will be influenced by its decisions in the Conceptual Framework project. However, the IASB will have to make a separate decision regarding the timing and extent of any work to improve IAS 32. Of the approaches being considered, we note that:

    (a) The settlement approach and the narrow equity approach are inconsistent with the classification outcomes of IAS 32. Therefore, a tentative decision to pursue one of those approaches in the Conceptual Framework would imply that the IASB may need to undertake a fundamental review of IAS 32 at some point[2]. However, the IASB could still decide to undertake a limited scope review of IAS 32 in the meantime.

    (b) The value approach, and the combined settlement and value approach are more consistent with the classification outcomes of IAS 32 than the other two approaches. Therefore, a tentative decision to pursue one of those approaches in the Conceptual Framework would imply that a limited review of IAS 32 may be sufficient. However, even if these approaches are pursued, the IASB might still decide that a more fundamental review of IAS 32 is required to clarify the principles

[2] Any such decision would need to go through the IASB's agenda setting process.

underpinning that standard, simplify the requirements and remove inconsistencies.

What is the objective of the research project?

25. 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.
26. Until now, and consistently with the IASB's views expressed in the Feedback Statement on its Agenda Consultation, the objective of this research project was 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.
27. The next step in the research project is to investigate whether the IASB should consider adding to its active agenda a project to develop a new Standard, or amend existing Standards, to address the problems identified. Agenda Paper 7C includes an overview of the conceptual and practice problems with the current requirements.

What challenges will this project face?

28. 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.
29. There are a number of reasons why a Standards-level project could fail to address the problems 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.

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

    (a) the universe of claims is continuous, not discrete. Using a binary distinction to split this continuous set into two discrete types of claim (liabilities and equity) 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 and has historically been implemented differently in different jurisdictions. That history might drive peoples' views on their preferred 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 produce similar economic outcomes in different ways using different types of financial instruments (structuring), therefore comparability is vital but difficult to achieve.

31. Nevertheless, we do not think that the IASB should take the research project off its agenda. We think 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. We note that the IASB has already begun to consider the distinction between liabilities and equity in more detail for the Conceptual Framework.

(b) There have been an increasing number of issues (some of them remaining unresolved) submitted to the IFRS Interpretations Committee. These issues highlight some of the inconsistencies, complexity and counterintuitive results when classifying items as liabilities or equity. Furthermore, many of those submissions raise concerns about the fundamental principles in IAS 32 and thus have been referred to the IASB anyway. That was the case with the submissions to the Committee on economic compulsion, foreign currency convertible debt, rights issues, puttable instruments, and put options written on non-controlling interests.

How should the IASB proceed with the research project?

32. We think that there are two broad alternatives that the IASB could consider for how to proceed with the research project:

(a) A fundamental review of IAS 32 (paragraphs 33–36); or

(b) Maintenance of IAS 32, together with improvements to presentation and disclosure requirements (paragraphs 37–43).

A fundamental review of IAS 32

33. The IASB could redeliberate all the Standards-level requirements for the distinction between liabilities and equity instruments in IAS 32. The IASB would undoubtedly build on its prior discussions and the work done in the Conceptual Framework project, however it would not be restricted by the ‘baggage’ of the existing requirements in IAS 32. This alternative is akin to starting with a clean sheet of paper (with the benefit of having done a significant amount of research).

34. Some respondents to the IASB’s Agenda Consultation said that the Board should perform a fundamental review with the objective of replacing IAS 32 to address the problems in paragraph 18 above.

35. Furthermore, a fundamental review may 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.

36. However a fundamental review would require more resources and time, and will be challenging to complete. It is not clear whether there is sufficient demand for a fundamental review to justify the resources and time required for its completion. Some respondents to the Agenda Consultation stated that the IASB deliberated the FICE project for several years and was unable to develop an approach that was an improvement to IAS 32. Therefore, the Board should not devote any more time to that project at this point in time.

Maintenance of IAS 32 with improvements to presentation and disclosure

37. The IASB could decide to undertake a narrow-scope project to amend particular requirements in IAS 32 to address the areas with the most significant practice problems.

38. Some respondents to the IASB's agenda consultation document stated that the IASB should re-consider the following requirements[3]:

(a) fixed-for-fixed condition;

(b) classification of puttable and mandatorily redeemable instruments; and

(c) accounting for convertible debt.

39. Other respondents noted that the IASB should formulate narrow and focused improvements to IAS 32 but did not provide further information about what those improvements should be. A few respondents suggested that the IASB reconsider other issues, including the effect of economic compulsion (and other non-contractual terms and conditions) on an instrument's classification.

40. Consistently with this alternative, in their comment letters on the IASB's *Financial Instruments with Characteristics of Equity* Discussion Paper in 2008, some respondents suggested that the IASB use IAS 32 as a starting point for their

[3] Agenda Paper 7C includes a more detailed list of known practice problems that could be candidates for a narrow-scope improvement project.

deliberations. Those respondents suggested that such an approach would be more efficient than ‘starting over’ and noted that most of the requirements in IAS 32 are working well in practice and have been for many years. While there may be requirements (eg the fixed-for-fixed condition) that are unclear, the costs of a fundamental change may exceed the benefits. Moreover the recent financial crisis did not highlight any significant deficiencies in the requirements in IAS 32.

41. However, the topics listed in paragraph 38 are complex and relate to the primary principles that underpin IAS 32 (ie the existence of a contractual obligation to deliver cash (or other assets) and the fixed-for-fixed condition). Therefore, there is a risk that any resulting amendments would weaken IAS 32 by creating additional exceptions. In other words, there is a risk that additional rules will be ‘bolted onto’ IAS 32. Introducing additional exceptions will make the Standard more complex, rules-based, and internally inconsistent.

42. In addition, there are consistent calls from investors and other users to improve the presentation and disclosure of troublesome instruments. Frequent requests from users and investors include improvements to the depiction of potential dilution, for example through scenario analysis. 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.

43. The IASB has noted 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 (such as credit risk and changes in the value of instruments puttable at fair value).

    (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.

(c) Introducing requirements for updating the carrying amount of some classes of equity instruments.[4]

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

Question for ASAF members
We would welcome ASAF members views on: (a) Which of the above alternatives they would suggest the IASB pursue? (b) Why they prefer this alternative? (c) What are the risks they perceive to that alternative?

[4] At its March 2014 meeting, some ASAF members stated that further work is needed on the suggestion in the Conceptual Framework Discussion Paper that the reported amounts for some classes of equity claims should be updated. However, others disagreed with the idea that the reported amounts for equity claims should be updated.

Appendix A—Tentative decisions and staff recommendations in the Conceptual Framework project

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

    (a) should keep the existing binary distinction of 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 liabilities and equity; and

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

45. In Agenda Paper 10H of the IASB's June 2014 meeting we identified the following characteristics of claims and the associated effect of those characteristics on assessments made by users:

    (a) Information about the economic resources required to settle an obligation, and the timing of settlement, will help users assess the liquidity of an entity and its requirements for additional financing.

    (b) Information about the drivers of the amount required to settle an obligation will help users assess the entity's solvency, its ability to obtain additional finance and the effect of the obligation on the distribution of returns.

    (c) Information about the drivers of possible future changes in value of different classes of claims will help users assess the distribution of returns.

46. In Agenda Paper 10H for the IASB's June 2014 meeting we identified four approaches to distinguishing between liabilities and equity:

    (a) **Settlement approach**—helps users assess the entity's liquidity and its needs for additional finance by depicting as liabilities all obligations that require the entity to transfer its economic resources.

    (b) **Value approach**—helps users assess the entity's solvency and its ability to raise additional finance by depicting as liabilities all obligations that will require the entity to transfer its economic resources, or transfer new claims against it, if the amount of those resources or claims to be transferred is independent of the entity's total economic resources.

(c) **Combined settlement and value approach**—helps users assess the entity's liquidity and its solvency by depicting as liabilities all obligations that will require the entity to:

(i) transfer its economic resources (regardless of how the value is specified); or

(ii) transfer its claims if the amount of claims to be transferred is specified by a value that is independent of the entity's total economic resources.

(d) **Narrow equity approach**—helps users assess how the most residual class of claim shares in returns.

47. For the September IASB meeting:

(a) the staff intend to recommend that the **combined settlement and value approach** would provide the most useful information that can be provided by the distinction between liabilities and equity. That approach classifies as liabilities both:

(i) obligations that require an entity to transfer its economic resources; and

(ii) obligations that require an entity to transfer a claim against the entity having a value independent of the entity.

(b) we note that, while both the settlement approach and the value approach are worth exploring, distinguishing between liabilities and equity using such 'pure' approaches may lead to anomalous results, including:

(i) for the value approach, some claims that will oblige the entity to transfer its economic resources may be classified as equity (eg puttable shares). This may be counterintuitive to users, who may expect that all claims within equity are permanent (or perpetual). Moreover, the value approach would make it easy to change the structure of claims, to achieve either debt or equity classification, without changing the liquidity risk created by the claim (ie to classify 'flighty funding' as equity).

(ii) for the settlement approach, some claims that promise a fixed amount of value may be classified as equity if the entity has the option (or is required) to settle the obligation with its own shares. The returns on those claims are very similar to interest, and the settlement approach would present those returns as changes in equity, which may also be counterintuitive to users. Moreover, if markets for an entity's equity instruments are liquid, the settlement approach would make it easy to change the structure of claims, to achieve either debt or equity classification, without changing the distribution of the returns on the claim.

(c) we do not think that the narrow equity approach would provide the most useful information that can be provided by the distinction between liabilities and equity. This is because, as shown in the analysis, many factors affect the distribution of returns to claim holders, and these factors may change over time, including which claim is the most residual.

48. At the September 2014 meeting, we also intend to discuss the consequences for the Conceptual Framework of pursuing the approaches explored above, and we will provide the ASAF with an oral update of any relevant tentative decisions made.

Appendix B—EFRAG's Discussion Paper

50. EFRAG's starting point, like the IASB's analysis in Agenda Paper XB of September, is to use Chapter 1 of the existing Conceptual Framework (in particular, paragraph OB13) to derive the objectives of classifying claims. The objectives identified are to depict, or contribute to depicting[5]:

    (a) An entity's liquidity;

    (b) An entity's solvency;

    (c) An entity's financial performance; and

    (d) Returns to the holders of a particular class of instrument.

51. EFRAG notes that some of the above objectives may conflict with each other, and introducing additional elements (that are neither liabilities nor equity) may assist in addressing some of the conflicts between objectives.

52. EFRAG identifies the following choices that need to be made (we have indicated the tentative decisions of the IASB):

    (a) The number of elements that claims are classified into.

        As noted in Appendix A, the IASB has tentatively decided in the Conceptual Framework project to keep the existing binary distinction between liabilities and equity. However, the IASB noted that additional classes within liabilities or within equity could help to depict different characteristics.

    (b) Whether the binary distinction should be defined by:

        (i) a positive definition of equity. This choice may depend on whether the proprietary perspective or entity perspective is taken.

            The IASB has tentatively decided in the Conceptual Framework project that the entity perspective should be taken. The staff recommendation is to define equity as the residual element.

[5] EFRAG's descriptions of liquidity and solvency are based on, and consistent with, the descriptions proposed in Agenda Paper 10H of June 2014.

(ii) a positive definition of a liability. Including determining whether an obligation exists and what the obligation requires transfer of.

The IASB has tentatively decided that an entity has a present obligation to transfer an economic resource as a result of past events if both:

- *the entity has no practical ability to avoid the transfer; and*
- *the amount of the transfer is determined by reference to benefits that the entity has received, or activities that it has conducted, in the past.*

(iii) a positive definition of both a liability and equity. Including deciding how to deal with overlaps and gaps.

(c) The unit of account, including separation and linkage requirements.

The IASB has tentatively decided in the Conceptual Framework project that the unit of account should be dealt with in individual IFRSs.

53. EFRAG's discussion paper can be accessed here:

http://www.efrag.org/Front/n1-1346/EFRAG-Discussion-Paper-Classification-of-Claims.aspx

Appendix C—Feedback from CMAC and GPF meeting

54. We had a brief discussion on 30 June 2014 regarding the distinction between liabilities and equity with members of the Global Preparers Forum (GPF) and the Capital Markets Advisory Committee (CMAC). We used the approaches in identified in Appendix A to illustrate different ways of making the distinction.

55. Apart from one or two exceptions, views appeared to be polarised between preparers and users. Preparers tended to lean towards a settlement approach and users tended to lean towards a narrow equity approach. This reflected concerns that each had regarding the approaches they did not favour:

    (a) Regarding the settlement approach, users were concerned that if an entity could settle debt-like instruments using the entity's own shares, that fact could lead to classification as equity.

    (b) Regarding the narrow equity approach, preparers were concerned that profit or loss (or other comprehensive income) could include income and expense driven solely by changes in the value of the reporting entity's own shares.

    (c) There was little to no support for the value approach.

56. Views were driven primarily by concerns about complexity. Both preparers and users were seeking a simple and intuitive approach to the distinction, however they leaned towards opposite ends of the spectrum. They found the settlement and narrow equity approaches to be more intuitive and simple than the value approach.

57. Users requested more disclosure regarding equity instruments, including dilution, terms, and information to help determine cost of capital.

58. Preparers were also concerned about the consequences of potential changes in the classification of items, including consequences for covenants and contracts based on existing debt/equity ratios, prudential regulatory requirements and potential divergence from US GAAP.