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Project	**Financial Instruments with Characteristics of Equity research project**
Paper topic	Overview of common concerns and criticisms

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Introduction

1. The objective of this paper is to highlight some of the most common and significant concerns and criticisms of the requirements in IAS 32 *Financial Instruments: Presentation* relevant to distinguishing between liabilities and equity. Agenda Paper 7B provides an overview of those requirements.

2. In discussing the concerns and criticisms, we try to distinguish between:

   (a) Issues regarding the underlying principles/concepts and usefulness of the resulting accounting outcomes ('conceptual issues') (paragraphs 5–19); and

   (b) Issues related to the interpretation or implementation of particular requirements ('practice issues') (paragraphs 21–44).

3. We will focus on the conceptual issues with IAS 32 and cover the practice problems briefly. If the IASB decides to pursue a more fundamental revision of the distinction used in IAS 32, then some of the practice problems arising from that Standard may be less relevant. However, if the IASB decides to pursue a narrower project on IAS 32, we can explore the practice problems in more detail at a later meeting.

4. We have not attempted to create an exhaustive list. Where possible, we have noted specific issues that have been submitted to the IFRS Interpretations Committee (the Interpretations Committee)—and the Interpretations Committee's

response. We have also noted some relevant comments from the responses to the IASB's Agenda Consultation 2011 and the IASB's 2013 Discussion Paper *A review of the Conceptual Framework for Financial Reporting* (the Conceptual Framework DP).

Conceptual issues with the distinction in IAS 32

5. Some constituents believe that particular requirements in IAS 32 are clear but do not result in useful information. These are typically concerns regarding the suitability of the two basic principles for distinguishing liabilities from equity and the resulting accounting. Some of these concerns resulted in the narrow-scope amendments that introduced the two exceptions described in paragraph 8 of Agenda Paper 7B.

6. We discuss the following conceptual issues below:

   (a) Inconsistencies with the Conceptual Framework and IFRS 2 *Share-based Payments* definitions paragraphs (7–8)

   (b) Foreign currency convertible debt (paragraphs 9–10)

   (c) Redeemable instruments classified as liabilities (paragraphs 11–12)

   (d) Cases where redemption is almost certain but no contractual obligation exists (paragraphs 13–16)

   (e) Accounting for 'grossed-up' derivatives (paragraphs 17–20)

Inconsistencies with the Conceptual Framework and IFRS 2

7. The definitions of financial asset and financial liability in IAS 32 are inconsistent with the existing definitions of an asset and a liability in the Conceptual Framework. The differences arise primarily because the Conceptual Framework definitions do not have a fixed-for-fixed condition. As a result, some contracts that are settled with the issuer's own equity instruments are classified differently in accordance with IAS 32 than they would be classified in accordance with the Framework. The Basis for Conclusions on IAS 32 does not explain the reasons

for the departure, however in Agenda Paper 7B we provide a brief history of the amendments leading to its development.

8. The definitions in IAS 32 also are different from those in IFRS 2. IFRS 2 essentially treats any transaction that falls within its scope as an equity instrument if the transaction must be settled with the issuer's own equity instruments, regardless of whether the number of equity instruments to be delivered is fixed or variable. We are aware that some entities take advantage of this difference and structure particular contracts so that they fall within the scope of IFRS 2 rather than IAS 32 and thus achieve equity classification. Appendix A of Agenda Paper 7B includes a brief outline of the relevant requirements in IFRS 2.

Foreign currency convertible debt

9. In April 2005 the Interpretations Committee concluded that if the conversion option embedded in convertible debt is denominated in a currency other than the issuing entity's functional currency, the amount of cash to be received is variable. As a result, the conversion option is a financial liability (ie there is no equity component). However, the Interpretations Committee also concluded that this outcome was not consistent with the IASB's intentions when it introduced the fixed-for-fixed condition in IAS 32. Therefore, it recommended that the IASB amend IAS 32 to permit a conversion option or a stand-alone option to be classified as equity if the exercise price is fixed in any currency. However, in September 2005 the IASB decided not to proceed with that proposed amendment to IAS 32. Also, when the IASB amended IAS 32 in October 2009 to introduce the exception for foreign currency denominated rights issues (see paragraph 8(b) in Agenda Paper 7B), it decided not to extend that conclusion to other instruments such as convertible debt (see paragraph BC4K in IAS 32).

10. Many constituents continue to believe that such options should be classified as equity, consistently with the Committee's recommendation in 2005.

Redeemable instruments classified as liabilities

11. Some entities issue only instruments that contain a contractual obligation to deliver cash—eg many cooperatives, private companies, and partnerships issue

only instruments that are redeemable at the option of the holder or are automatically redeemed upon the occurrence of an event that is certain to occur (eg the death of the holder). Unless those instruments meet the detailed rules set out in the amendment to IAS 32 that was made in 2008 and is described in paragraph 8(a) of Agenda Paper 7B, they are classified as financial liabilities. As a result, the entity may not have any instruments that are classified as equity and all of its liabilities would be remeasured in accordance with IAS 39 or IFRS 9 with changes recognized in profit or loss.

12. Some believe that such classification does not result in useful information because those instruments economically represent a residual interest in the net assets of the entity and, therefore, should be classified as equity (and not remeasured).

Redemption is almost certain but no contractual obligation exists

13. A financial instrument that does not contain a contractual obligation to deliver cash (or to deliver another financial asset) does not meet the definition of a financial liability and, thus, is an equity instrument. An example is a perpetual preferred share with discretionary periodic dividends. In some cases, if that preferred share is not redeemed (called) by the issuer before a particular date, any dividend is significantly increased (a 'step-up clause'). This may be combined with a 'dividend blocker', which prohibits the entity from paying dividends on other (usually more subordinate) instruments unless dividends are paid on the preferred share. In those cases, some believe that that the entity is economically compelled to redeem the preferred shares before the step-up clause is triggered; however, it is not contractually obliged to do so—therefore, the instrument is an equity instrument even though it is almost certain that it will be redeemed. Some believe that such classification does not provide useful information.

14. Moreover, some believe that the distinction between economic compulsion and an indirect obligation is unclear in some cases. Some compare the instrument described in the preceding paragraph (ie a preferred share with a step-up clause) with a non-derivative instrument that the entity can choose to settle with either cash or a fixed number of its own shares and express the view that those two instruments should have the same classification.

15. A few respondents to the IASB's 2011 Agenda Consultation stated that the IASB should reconsider the issue of economic compulsion. Those respondents seemed to suggest that particular non-contractual terms or conditions should affect the classification of a financial instrument. The Conceptual Framework DP included additional guidance on the definition of a liability and including how economic compulsion should be considered in deciding whether a liability exists or not.

16. At its July 2014 meeting, the IASB, in its Conceptual Framework project, has tentatively decided that an entity has a present obligation to transfer an economic resource as a result of past events if both:

    (a) the entity has no practical ability to avoid the transfer; and

    (b) 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.

Accounting for 'grossed-up' derivatives

17. As noted in Agenda Paper 7B, some put options and forward purchase contracts written on an entity's own equity instruments give rise to liabilities that are measured on a gross basis at the present value of the redemption amount. Some argue that recognizing changes in the measurement of that grossed-up liability in profit or loss does not result in useful information. For example, some believe that when a put option or forward contract is exercisable at the fair value of the underlying shares, recognizing in profit or loss remeasurements of that put option or forward contract produces counter-intuitive, volatile and misleading information. That is because the fair value of the standalone put or forward contract is close to zero (ie when the contract is exercised and the issuer is required to deliver cash, it will receive shares with an equal value in exchange). Therefore some constituents have suggested that derivatives written on an entity's own equity instruments should have the same measurement basis as other derivatives—ie measured on a 'net' basis at fair value.

18. Consistenly with that view, in 2010 the Interpretations Committee recommended that the scope of IAS 32 be amended to exclude some put options written on non-controlling interests in the parent's consolidated financial statements (NCI puts). That scope exclusion would change the measurement basis of those NCI puts to

be the same as that used for other derivatives. While some IASB members had sympathy for that accounting treatment, the IASB decided not to proceed with the proposed amendment to IAS 32. Among the IASB members' reasons were concerns about amending IAS 32 before deciding how to proceed with the FICE project and creating confusion about why NCI puts would be treated differently than other derivatives on an entity's own equity instruments.

19. In May 2012 the Interpretations Committee published a draft Interpretation on the accounting for NCI puts. That draft proposed to clarify that the financial liability that is recognised for an NCI put must be remeasured in accordance with IAS 39 and IFRS 9, which require that changes in the measurement are recognised in profit or loss. After discussing the comments received on the draft Interpretation, the Interpretations Committee expressed the view that better information would be provided if NCI puts were measured on a net basis at fair value, consistently with derivatives that are within the scope of IAS 39 and IFRS 9 (and consistent with their previous views expressed in 2010).

20. In the light of the Interpretations Committee's views and the feedback received in the comment letters, 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 should be measured on a net basis at fair value.

Practice problems

21. Areas of known application difficulties include:

    (a) Interpretation of the 'fixed-for-fixed' condition (paragraphs 22–26)

    (b) Accounting for convertible debt (paragraphs 27–31)

    (c) Identifying whether a contractual obligation exists (paragraph 32–34)

    (d) Contingent settlement provisions (paragraphs 35–36)

    (e) Reassessment of classification (paragraphs 37–39)

    (f) Accounting for 'grossed-up' derivatives (paragraphs 40–43)

    (g) Other issues (paragraph 44)

The fixed-for-fixed condition

22. As discussed in Agenda Paper 7B, a contract to exchange cash (or another financial asset) for an entity's own equity instruments is classified as an equity instrument only if both the amount of cash (or other financial asset) and the number of equity instruments are fixed. This raises questions about what 'fixed' means and whether there are particular types of variability that do not violate the fixed-for-fixed condition. On the basis of submissions to the Interpretations Committee, we understand that application of the fixed-for-fixed condition is a widespread practice issue. Moreover these issues arise both in the context of standalone financial instruments (eg a written put option) and features embedded in another instrument (eg the conversion option in convertible debt).

23. Broadly, the issue asks whether 'fixed' means:

    (a) 'never changes';

    (b) 'predetermined'—and if this is the correct interpretation, whether any predetermined variability can be considered fixed or only particular types; or

    (c) something else.

24. The questions relate to both the number of equity instruments and the amount of cash or other financial asset:

    (a) A contract to exchange the entity's own equity instruments for another financial asset (eg another entity's shares) can also meet the definition of an equity instrument. That raises questions about what 'a fixed amount of another financial asset' means—specifically, whether it is a fixed value (a variable number of the other entity's shares to equal a fixed monetary value); a fixed volume (a fixed number of the other entity's shares); or something else.

    (b) A similar question relates to a contract that obliges an entity to exchange a fixed number of shares of one class of its own equity (eg the entity's perpetual preferred shares) for a fixed number of shares of another class (eg the entity's perpetual ordinary shares). Or alternatively, the contract may oblige the entity to exchange a fixed

number of its own shares for a fixed number of its subsidiary's shares. Some have asked if those contracts are classified as equity or if the contract is outside the scope of IAS 32 because cash (or another financial asset) is not exchanged. If those contracts should be classified as equity, some have asked whether that conclusion would change if there is variability in the number of shares being exchanged.

(c) Furthermore, some have pointed out that the conversion option in convertible debt obliges the entity to exchange its own equity instruments for the forgiveness (extinguishment) of its liability (whose fair value is likely to change over its term) rather than for a fixed amount of cash or another financial asset—and thus question whether such conversion features should satisfy the fixed-for-fixed condition.

(d) A final example related to the fixed-for-fixed condition is an instrument that has no contractual obligation to pay cash but has a conversion feature that is not fixed-for-fixed. Consider an instrument that does not have a repayment (maturity) date and has only discretionary interest payments (ie the issuer has the unconditional right to cancel an interest payment for any reason). However, the instrument is mandatorily convertible in particular circumstance (eg if the issuer's tier 1 capital for bank regulatory purposes falls below a specified level)—or is convertible at the option of the holder at any time—into a variable number of common shares. There are at least three different views on how this instrument should be classified.

25. While we understand that practice has developed to address many of the questions related to the fixed-for-fixed condition, anecdotal evidence suggests that such practice is diverse. In January 2010 the Interpretations Committee acknowledged that such diversity exists but decided not to add this issue to its agenda because, at the time, the FICE project was on the IASB's active agenda.

26. Several respondents to the IASB's agenda consultation document stated that the IASB should clarify the fixed-for-fixed condition by providing additional guidance on the meaning of 'fixed' but those respondents did not comment on any specific issues.

Accounting for convertible debt

27. In addition to the issues described in the preceding section related to whether a conversion feature satisfies the fixed-for-fixed condition, there are other aspects of accounting for convertible debt that are problematic in practice. For example, it is common that convertible debt is also puttable by the holder or callable by the issuer (or both). Assuming that the conversion feature satisfies the fixed-for-fixed condition and thus is classified as an equity component, many have questioned how to subsequently measure the liability component (ie the puttable or callable debt). That is because the equity conversion feature will affect whether (and when) the put and call options are exercised. Some have asked whether the effective interest rate that is used to measure the liability component should be based on the expected life of 'plain' puttable or callable debt (ie without an equity conversion feature) or whether the expected life should reflect the interaction with the equity component.

28. Some have asked how to account for particular methods of settling (extinguishing) convertible instruments. IAS 32 provides guidance for conversion at maturity, repurchase before maturity through an early redemption (repurchase), and amendment of the instrument's terms to induce early conversion. However some have raised questions about how to account for a convertible instrument that is converted, put or called before maturity.

29. Also, some have asked whether it is appropriate (and if so, when) to separate an asset component from a compound instrument (ie as opposed to only equity and liability components).

30. Others have asked about the correct accounting treatment for 'reverse convertible debt' where the issuer, as opposed to the holder, has the choice to settle the principal amount outstanding with cash (or another financial asset) or a fixed number of its own equity instruments. This raises the question whether the issuer has a contractual obligation to deliver cash (or another financial asset) because it can choose to deliver a fixed number of its own equity instruments. There are at least two different views in practice on how this instrument should be classified.

31. A similar example is an instrument where the issuer has the choice to settle the principal amount outstanding with a variable number or a fixed number of its own

equity instruments. As in the preceding example, the issuer has an unconditional right to settle the contract by delivering a fixed number of its own equity instruments.

Whether a 'contractual obligation' exists

32. To apply IAS 32, it is imperative that the entity determine whether it has a contractual obligation to deliver cash (or another financial asset). In some cases, it may not be a straight-forward determination. For example, some have noted that it is sometimes difficult to distinguish an indirect contractual obligation from economic compulsion. IAS 32 is clear that the former gives rise to a liability (because the obligation is established by the contractual terms and conditions of the instrument) but the IASB confirmed in 2006 that the latter alone does not.

33. Also, in March 2010 the Interpretations Committee discussed a request for guidance on whether a financial instrument is a financial liability or equity instrument if a distribution (dividend) is at the ultimate discretion of the issuer's shareholders. The Committee acknowledged that diversity may exist in practice in 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. But the Committee decided not to add that issue to its agenda because, at the time, the FICE project was on the IASB's active agenda. Some have told us that this continues to be a widespread issue, especially with owner-managed businesses where the directors are also the shareholders and it is difficult to determine the capacity in which they are operating.

34. Similar questions arise when there is a statutory requirement for an entity to make distributions (dividends), which is common in particular jurisdictions (such as Brazil). Sometimes it can be difficult to distinguish a contractual obligation from a statutory obligation—and some argue that statutory requirements are outside of the scope of IAS 32 since they are not contractual. Others argue that the terms and conditions of the contract include any relevant laws (oftentimes this position is based on paragraph 5 of IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments*). This issue is further complicated if the distributions on another class of instruments are contractually linked to those instruments with

statutory distributions —or if the contract sets out a distribution that is different from the statute. If the statutory distributions give rise to a financial liability, some have asked how it should be measured (eg as and when profits are made or on the basis of all future expected profits).

Contingent settlement provisions

35. As noted earlier in this paper, a financial instrument that has a contingent settlement provision is a financial liability unless that settlement provision is 'not genuine' or arises only upon liquidation of the issuer.

36. Constituents have raised questions about whether particular events are within the control of the issuer (eg a change in control of the issuer or a suspension of the listing of the issuer's shares from trading on a stock exchange). Additionally, there have been questions about the meaning of 'not genuine'. There are two general views—the first view believes that the determination is a probability assessment while the second view believes that something is not genuine only if it is 'counterfeit' or has 'no commercial substance'. Furthermore, some have asked whether it is considered 'liquidation' if the insolvency procedures may result in an entity being restructured rather than dissolved.

Reassessment of classification

37. Many have asked whether IAS 32 requires, permits, or prohibits reclassification (from equity to non-equity or vice versa). The terms of the financial instrument may be modified in such a way that although it met the definition of a financial liability when it was initially recognized, it does not when the terms are modified (or vice versa). Or, the terms of the instrument may remain unchanged, but circumstances may change (eg the entity may change its functional currency; the entity may write a call option over its subsidiary's shares and subsequently dispose of the subsidiary but the call option remains outstanding (ie the call option is no longer written on the group's own equity); or a conversion feature may require the entity to deliver a variable number of its own equity instruments until a specified date when the number becomes fixed).

38. The Interpretations Committee was asked in November 2006 to consider a situation in which an amendment to the contractual terms of an equity instrument resulted in the instrument being subsequently classified as a financial liability. The Committee did not take this issue onto its agenda. However it observed that the change in the terms of the instrument gave rise to derecognition of the original equity instrument and that the difference between the carrying amount of the equity instrument and the fair value of the newly recognized financial liability should be recognized in equity.

39. But questions persist in practice about whether reclassification is required (or permitted or prohibited) in other circumstances.

Accounting for 'grossed-up' derivatives

40. Some put options and forward purchase contracts written on an entity's own equity instruments give rise to liabilities that are measured on a gross basis at the present value of the redemption amount. The IASB and the Interpretations Committee recently discussed an issue related to the accounting for put options written on shares held by non-controlling interest shareholders in the consolidated financial statements of the controlling shareholder (NCI puts). Specifically constituents asked whether changes in the measurement of that liability should be recognized in profit or loss or equity.

41. While that issue is relatively narrow, there are broader questions related to the accounting for grossed-up put options and forward contracts. For example, some have asked which equity account should be debited at initial recognition (ie whether the shares (or NCI) should be derecognized). This raises additional questions, such as how to recognize dividends paid on the underlying shares (ie are those dividends an expense or a distribution?) and how to compute earnings per share (ie are the shares still outstanding for the purpose of that computation?).

42. In November 2006 the Interpretations Committee discussed some of those broader questions in the context of NCI puts (and forwards) and acknowledged that there was divergence in how to account for the debit to equity when the instrument is initially recognized. But the Committee did not add that item to its agenda because it did not believe that it could reach a consensus on a timely basis. The

Committee discussed similar questions in 2010 (again in the context of NCI puts) but did not reach a consensus.

43. As noted in the previous section, some constituents believe that measuring puts and forwards written on an entity's own equity instrument on a gross basis does not result in useful information.

Other issues

44. As we noted earlier in this paper, we have not attempted to create an exhaustive list of the criticisms of IAS 32 or the resulting practice problems. However in an effort to illustrate the variety of issues that have been raised, we have listed some additional topics below:

    (a) The appropriate accounting when an entity enters into a repurchase agreement on its own equity instruments (ie the entity issues shares with an obligation to repurchase them in the future)—Some believe that it is appropriate to analogize to the derecognition requirements in IAS 39 and IFRS 9 (ie with the result that, in some cases, neither the issuance nor the forward purchase contract are recognized). Others believe such an analogy is not appropriate and that the entity must recognize the issuance of the shares and a forward purchase contract. While the balance sheet generally would be the same at initial recognition, the treatment of dividends and earnings per share calculations could be different.

    (b) The appropriate accounting when an entity issues equity instruments but does not require payment from the counterparty until a future date—Some believe that the entity should recognize a receivable (ie an asset) for the amount due while others believe that the entity should recognize the balance due as a reduction in equity. Others have suggested that the entity should recognize equity only to the extent that the counterparty has paid for the instruments.