STAFF PAPER

September 2014

IASB Meeting

Project	Financial Instruments with Characteristics of Equity research project
Paper topic	Overview of previous projects to improve IAS 32

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Introduction

1. The IASB had a previous project to address liability and equity issues in IAS 32. That project resulted in the publication of the discussion paper *Financial Instruments with Characteristics of Equity* (the IASB FICE DP) in February 2008 and was subsequently suspended in October 2010 when the IASB reassessed its agenda. At that time, the IASB 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. As we describe in this section, a significant amount of work was done before the project was paused.

2. The FICE project was conducted under the Memorandum of Understanding (MoU) between the IASB and the US Financial Accounting Standards Board (FASB). The boards' objective was to develop converged requirements for distinguishing equity instruments from non-equity instruments that were an improvement to both US generally accepted accounting principles (US GAAP) and IFRSs. However, work on liabilities and equity classification predates the IASB project.

3. This section includes a brief summary of:

   (a) previous work by the FASB (paragraphs 4–7);

   (b) the early days of the MoU FICE project (paragraphs 8–12); and

   (c) the latter days of the MoU FICE project (paragraphs 13–23).

Previous work by the FASB (pre-IASB)

4. Before the FASB's codification project, more than 60 pieces of literature addressed various aspects of accounting for liabilities and equity. Most of the US GAAP literature addresses specific narrow issues and was developed as the issues arose. Thus, the FASB has historically taken the lead on this particular topic.

5. The FASB's project was initiated in 1986 to address financial reporting issues that were arising, or that were given a new sense of urgency, as a result of financial innovation. In August 1990, the FASB published a Discussion Memorandum *Distinguishing between Liability and Equity Instruments and Accounting for Instruments with Characteristics of Both*. Subsequently, the FASB suspended work on the liabilities and equity project to devote its resources to financial instruments projects that it judged to be more urgent at the time. The project was reactivated in December 1996. That effort led to the publication of two exposure drafts in October 2000:

   (a) *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both* (2000 FASB ED); and

   (b) *Proposed Amendments to FASB Concepts Statement No. 6 to Revise the Definition of Liabilities* (2000 FASB Concepts ED).

6. The 2000 FASB ED addressed a broad range of liability and equity classification issues. Although the FASB had not finished discussing all of the issues addressed in that exposure draft, it decided to issue Statement 150 *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* in May 2003 to provide necessary and timely guidance for certain troublesome instruments for which the practice problems were clear and resolvable. However, shortly after the issue of Statement 150, constituents raised questions about some types of mandatorily redeemable instruments. To give itself time to resolve those issues, the FASB deferred the effective date of some parts of Statement 150. The FASB planned to continue discussing the remaining issues discussed in the 2000 FASB ED and issue another Statement at a future date. However, changes in the 2000 FASB Concepts ED were also delayed because the FASB thought that resolution of the remaining issues in the 2000 FASB ED could affect any modification to the definition of a liability.

7. Subsequently , the FASB changed its plan and attempted to develop a convergent set of classification principles that would avoid the issues raised by Statement 150, as well as resolve the remaining issues.

The early days of the MoU FICE project (until September 2008)

8. In February 2006 the IASB and the FASB published a Memorandum of Understanding (MoU) affirming their commitment to convergence. One of the goals for 2008 set out in the MoU was 'to have issued one or more due process documents relating to a proposed standard' on the distinction between liabilities and equity.

9. Leveraging its prior work, the FASB led the first phase of the MoU FICE project and in November 2007 published a Preliminary Views document *Financial Instruments with Characteristics of Equity* (PV). That PV set out three approaches for identifying equity instruments. The FASB unanimously preferred one of the approaches, which was called the basic ownership approach (BOA). Under the BOA, only the most subordinate instruments issued by the entity would be classified as equity. As a result, all derivatives and preferred shares (including those that are perpetual with discretionary dividends) would be classified as non-equity. This approach classified significantly fewer instruments as equity than IAS 32 (and US GAAP) and, therefore, would have been a significant change to practice. Moreover, it raised difficult questions about whether, and if so how, some of those non-equity instruments (eg perpetual preferred shares) would be subsequently measured.

10. In February 2008 the IASB published the IASB FICE DP. This contained the FASB's PV and an IASB invitation to comment, which included some background information relevant to IFRS constituents and asked additional questions. However the IASB did not deliberate the three approaches in the PV, nor did it have a preferred approach.

11. In July 2008, consistently with the recommendation of the IFRS Advisory Council (then called the Standards Advisory Counsel (SAC)) the IASB moved the FICE project from its research agenda to its active agenda. At that time, the IASB

agreed that the FICE project met all five agenda criteria in its due process handbook.

12. The comment period on the IASB's DP ended in September 2008.

The latter days of the MoU FICE project (October 2008—October 2010)

13. In October 2008 the IASB discussed a summary of the comments received on its DP. The significant high-level comments were:

    (a) Respondents supported the boards' efforts to develop a converged and improved standard for distinguishing equity instruments from non-equity instruments.

    (b) Most expressed the view that the boards should finish their joint project on their conceptual frameworks before deliberating a standards-level project on distinguishing equity instruments from non-equity instruments.

    (c) A majority of respondents did not support using the three approaches described in the PV as a starting point. Some respondents said that IAS 32 was not fundamentally flawed and provided a better starting point. However, others (including many users) told us that IAS 32 is very difficult to understand and does not have a single, clear principle. Overall, users supported a simpler approach (and noted that the BOA was easy to understand and apply).

14. Both boards began their deliberations in October 2008 and, at that time, decided to develop an approach based on the following two principles:

    (a) All perpetual instruments are equity.

    (b) The most subordinate ownership instruments are equity (even if those instruments are puttable or mandatorily redeemable).

15. That starting point was different from IAS 32 because under the former:

    (a) all derivatives would be non-equity (ie it did not have a fixed-for-fixed condition like IAS 32 does) and

(b) more puttable and redeemable instruments would be equity (ie classifying some of those instruments as equity would not be a limited-scope exception as the 2008 amendments to IAS 32 are).

16. Over the next two years, the boards discussed the FICE project regularly (usually every month or every two months) and further developed their approach. While the two principles set out in paragraph 14 remained fundamental to that approach, over the course of their discussions, the boards expanded the definition of equity to include additional instruments.

17. The boards' approach was set out in a staff draft of the exposure draft *Financial Instruments with Characteristics of Equity*. The boards' aim was to publish that exposure draft in the second half of 2010 (and to finalize the requirements in 2011). The classification results under the boards' proposed approach were broadly similar to IAS 32. The proposed approach would have classified the following instruments as equity:

(a) all perpetual instruments;

(b) puttable and mandatorily redeemable instruments that form the foundation of an issuer's capital structure (ie redemption is required only if the holder dies or otherwise ceases to engage in activities with the issuer); and

(c) contracts (eg a written call option) that result in the holder becoming an owner of an equity instrument if the number of equity instruments and the assets to be received in return (if any) are 'specified' (as defined in the proposals).

18. Also as in IAS 32, the approach would have separated some instruments into equity and non-equity components (eg some convertible debt, perpetual instruments that paid mandatory dividends, and some puttable shares).

19. However, there were two primary differences between IAS 32 and the boards' proposed approach:

(a) Redeemable instruments: The detailed rules in IAS 32 for identifying which puttable and mandatorily redeemable instruments must be classified as equity would be replaced with a more principles-based

approach. That principle was intended to address many of the criticisms of the rules-based approach in IAS 32 and the IASB anticipated that more puttable and mandatorily redeemable instruments would meet the definition of equity under the proposed approach than under IAS 32. Additionally, under the boards' proposed approach, if a puttable instrument was not classified as equity in its entirety, it was separated (bifurcated) into an equity component (a perpetual share) and a non-equity component (a written put option).

(b) The fixed-for-fixed condition in IAS 32 was replaced by the 'specified-for-specified' condition. The meaning of 'specified' was intended to be broader than 'fixed' and thus address some existing practice problems (eg the amount of cash received could be 'specified' in the functional currency of the instrument holder). The IASB anticipated that more derivatives would meet the definition of equity instruments under the proposed approach.

20. There were other differences between the proposed approach and IAS 32, such as how the equity (and non-equity) components of convertible debt were measured and which derivatives written on an entity's own equity instruments were measured at the present value of the redemption amount (ie grossed up).

21. The boards circulated the staff draft of the proposals to a small group of external reviewers in the second quarter of 2010 and received over 600 comments. The two most significant concerns related to the overall approach were that the proposals lacked a clear principle (ie it was difficult to determine how to classify an instrument if it was not specifically described in the proposals) and, in some cases, the proposals provided inconsistent or illogical results.

22. In the light of those comments, in September 2010, the IASB decided to discontinue discussions on the proposed approach and instead discuss with the FASB whether the boards should pursue another solution—such as amend the requirements in IAS 32 to address specific practice problems and explore the adoption of the amended version of IAS 32 in US GAAP or make targeted improvements to both US GAAP and IAS 32 to increase convergence between the two sets of accounting standards.

23. In October 2010 the boards acknowledged that the FICE project was a lower priority and they did not have the capacity to devote the time necessary to deliberate it. Consequently, the boards decided to pause the project and not to issue an exposure draft in the near term. At that time, the IASB noted that a decision on if and how it would ultimately proceed with the FICE project would depend on the outcome of the ongoing deliberations about its future work plan.