STAFF PAPER

June 2015

IASB Meeting

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

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Introduction

1. At this meeting we will continue the discussion of the IASB's Financial Instruments with Characteristics of Equity research project.

2. The paper that we are discussing at this meeting is **Agenda Paper 5A Features of claims**.

3. At this meeting, we are seeking directional input, including whether we have adequately defined the various characteristics (or features) that might be relevant for classification purposes. We are not, at this stage, asking the IASB to form a preliminary view as to which characteristic(s) (or feature(s)) should distinguish liabilities from equity and which should distinguish sub-classes within liabilities and within equity.

4. This cover note also includes:

   (a) A summary of ASAF discussions in March 2015 (paragraphs 5–9)

   (b) A summary of the topics to be discussed at future meetings (paragraph 10)

ASAF discussions

5. At the March 2015 ASAF meeting the IASB staff:

   (a) provided feedback to ASAF members on the IASB's tentative decisions regarding the scope of the research project and the interaction with the *Conceptual Framework* project (paragraph 6); and

   (b) sought ASAF members' views on the implications for the research project of the feedback that the EFRAG received on its Discussion Paper *Classification of Claims* (paragraphs 7-9).

6. In discussing the scope of the research project and the interaction with the *Conceptual Framework* project, ASAF members discussed:

   (a) the difficulty in communicating the interaction between the two projects, but the necessity of doing so because the forthcoming Exposure Draft on the Conceptual Framework will include some proposed changes to the definition of a liability.

   (b) the point that equity instruments are not economic resources of an entity. One ASAF member stated that they are economic resources of the holders and, in that sense, the holder may be indifferent between receiving economic resources or equity instruments of the entity. Another ASAF member suggested that the focus of the classification should be on the state of the claim at the reporting date, not the possible state of the claim in the future: it was possible that a claim might be a liability at the reporting date even if future settlement by the issue of equity instruments was probable.

   (c) the entity versus proprietary perspectives of financial reporting. Some ASAF members suggested that the IASB should consider the implications of the perspective of financial reporting for the distinction between liabilities and equity. Other ASAF members suggested that considering the entity perspective would not provide any direction and would be more of a distraction.

   (d) the additional complexity introduced when considering consolidated entities. Some ASAF members stated that considering consolidation was beyond the scope of the project, nevertheless it may be relevant when considering the context of some of the problems.

(e) the feasibility of addressing some of the problems in the project without a fundamental rethink. Some ASAF members stated that some of the issues were to do with the fundamental principles of IAS 32 *Financial Instruments: Presentation*. The IASB staff stated that the objective would be to underpin some of those principles with a more robust basis, and to see whether other presentation and disclosure requirements could help alleviate the problems without shifting the classification of many other claims that do not present problems.

7. The EFRAG prepared the Discussion Paper to provide input into this research project. The EFRAG staff presented a paper outlining the issues that their Discussion Paper explored and the responses they received. The IASB staff presented a paper outlining the implications for the research project of the EFRAG's work. Paragraphs 8 and 9 outline the discussion that followed.

8. ASAF and IASB members commended the EFRAG for its work, with many noting that it was very informative and useful.

9. In discussing the implications of the EFRAG's work for the research project, ASAF members discussed:

(a) the competing objectives given the existing accounting outcomes of the classification. Different ASAF members placed a different priority on each of the objectives of depicting liquidity, solvency, performance and returns to holders of a particular class of instrument. Others stated that neither liquidity nor solvency could be completely depicted without a complete recognition and equivalent measurement of the assets. ASAF members suggested that the IASB should consider the objectives, but it should be aware that the financial statements as a whole need to meet those objectives. The distinction between liabilities and equity plays a role in meeting those objectives, but it cannot achieve those objectives in isolation.

(b) the objective of financial reporting and the need to meet users' information needs. One ASAF member stated that users have very diverse needs and it would not be possible to satisfy all of them. Another ASAF member stated that the overall needs of users needs to be understood, given that the objective of financial reporting is to satisfy common information needs. Some ASAF members stated that claims have many different characteristics and that a single distinction cannot communicate all of these differences. One IASB member suggested an enhanced statement of changes in equity as a possible solution. ASAF members acknowledged that the IASB will have to consider other ways of presenting information about claims, which would be relevant to users but that is not conveyed using the selected distinction. Some ASAF members stated that this was already done to depict dilution through earnings per share.

(c) whether a liability should be defined positively and whether equity should continue to be defined as a residual interest. Most ASAF members agreed with such an approach. Some ASAF members acknowledged that some objectives may be achieved by defining additional subclasses of liabilities or equity.

(d) whether measurement should be a consequence of classification. One ASAF member thought that how a claim should be measured is independent of the classification decisions. Other ASAF members thought that claims classified as equity could only be subject to indirect measurement as a residual; requiring direct measurement for some of these claims would be introducing a third element. Some ASAF members suggested that the more important issue was whether the subsequent changes in the measurement of a claim are income, expense or something else.

Next steps

10. In future meetings, the IASB will need to discuss the following:

    (a) What assessments do users make with the **statement of financial position**? What features of claims are relevant to those assessments?

    (b) What assessments do users make with the **statement of financial performance**? What features of claims are relevant to those assessments?

    (c) Which information needs have to be met using other presentation and disclosure requirements of other IFRSs?

    (d) Do we need to develop the following requirements, or can we borrow existing requirements from IAS 33 *Earnings-per-share*:

        (i) Definitions and recognition requirements for other classes and categories of equity?

        (ii) Requirements for updating the carrying amount of some classes of equity instruments? Where should changes in these carrying amounts be presented?

    (e) The requirements in IAS 32 for derivatives on own equity, including:

        (i) The challenges with accounting for derivatives on own equity

        (ii) How IAS 32 deals with those challenges, including discussing the ‘fixed-for-fixed’ condition and obligations in derivatives to redeem own equity instruments

    (f) The requirements in IAS 32 to do with:

        (i) Interaction of contractual rights and obligations with regulatory and legal overlays

        (ii) Substance over form

        (iii) Contingencies and conditionality

        (iv) Recognition, derecognition and reclassification of equity instruments (and components), including on settlement, conversion, expiration modification and other events.