STAFF PAPER

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Project	**Financial Instruments with Characteristics of Equity research project**		
Paper topic	Identifying the challenges and setting out an approach		
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Introduction

1. This paper discusses the main challenges with distinguishing between liabilities and equity under IAS 32 *Financial Instruments: Presentation*, and sets out how we intend to approach addressing these challenges as part of this project.

2. According to paragraph 5.4 of the Due Process Handbook, when deciding whether a proposed agenda item will address users' needs, the IASB considers:

   (a) whether there is a deficiency in the way particular types of transactions or activities are reported in financial reports;

   (b) the importance of the matter to those who use financial reports;

   (c) the types of entities likely to be affected by any proposals, including whether the matter is more prevalent in some jurisdictions than others; and

   (d) how pervasive or acute a particular financial reporting issue is likely to be for entities.

3. This paper is structured to match criteria above:

   (a) What are the challenges with the requirements of IAS 32? (paragraphs 5–29)

   (b) How are users affected by these challenges? (paragraphs 30-35)

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(c) Are the challenges more prevalent in some jurisdictions than others? (paragraphs 36–39)

(d) Which entities are affected by these challenges and to what extent? (paragraphs 40–41)

4. In paragraphs 42–48, we set out how we intend to approach addressing these challenges.

What are the challenges in the requirements of IAS 32?

5. In this paper, we try to distinguish between two different sets of challenges in IAS 32:

(a) **Conceptual**—These are challenges with the underlying rationale of, and approach to, the distinction between liability and equity in IAS 32 and in the Conceptual Framework. These challenges exist regardless of how well the requirements of IAS 32 are applied in practice. (See paragraphs 8–27)

(b) **Application**—These are challenges with the application of the requirements in IAS 32 to particular types of transactions in practice. These issues deal with the consistency, completeness, and clarity of those requirements and the appropriateness of any cost/benefit trade–offs, practical expedients and exceptions. (see paragraphs 28–29)

6. We think distinguishing between the two sets of challenges above will help because:

(a) Addressing the perceived conceptual challenges might result in a recommendation to add a project to amend IAS 32 *and/or* the Conceptual Framework.

(b) Addressing the perceived application challenges in IAS 32 might result in a recommendation to add a project to amend IAS 32, **but should not** affect the Conceptual Framework.

7. In theory, the consistency, completeness and clarity of the existing requirements in IAS 32 might be improved without reconsidering the underlying concepts, for

example by narrow scope amendments, or through a maintenance project run by the Interpretations Committee. However, the Interpretations Committee has, on more than one occasion, referred a particular transaction to the IASB on the basis that the perceived issue was broader than the particular transaction submitted. In our view, this indicates that it would be difficult to improve the consistency, completeness and clarity of the requirements without first **identifying, confirming (or correcting) and reinforcing** the underlying rationale of IAS 32.

What are the conceptual challenges?

8. In our view, the underlying conceptual challenges of distinguishing between liabilities and equity arise because of the interaction between:

   (a) the economic nature of claims against the entity (paragraphs 10-12); and

   (b) the polarised financial reporting effects of classifying claims as either liabilities or equity (paragraphs 13-18).

9. We illustrate these challenges using two particular types of instruments in paragraphs 19-27.

The economic nature of claims against the entity

10. Arguably, the existing binary classification evolved because it adequately represented the convenient off-the shelf contractual arrangements that existed at the time. However, there is no constraint against any of the parties from negotiating all the terms of an investment contract to suit their individual needs. Those terms include features (or characteristics) that distribute **the amount, timing and uncertainty** of cash inflows to the entity in different ways amongst the various claims against the entity.

11. Financial innovation has resulted in a wide array of various types of contracts, allowing entities to raise finance from a variety of investors with differing investment needs. Thus, market forces over time have resulted in a universe of claims that is continuous, wide and constantly changing in response to changes in investors’ appetites for risk and expected returns.

12. The following other aspects of claims also give rise to challenges:

(a) the ability to replicate similar economic outcomes in different ways. Modern financial innovation makes it easy to reproduce similar economic outcomes using various combinations of different features. This is commonly referred to as 'structuring'. Therefore comparability is vital but difficult to achieve.

(b) the terms of some claims may be ambiguous and/or complex. Financial reporting requirements cannot eliminate the ambiguity, complexity and uncertainty that exist in the real world. However, the financial reporting requirements need to enable users of financial statements to assess the extent of any uncertainty or complexity that exists when making investment decisions.

The polarised financial reporting effects of classifying claims as either liabilities or equity

13. The distinction between liabilities and equity is a fundamental part of IFRS (indeed most, if not all, accounting systems). It is found in the definitions of the elements in the *Conceptual Framework for Financial Reporting* and in the fundamental accounting equation:

$$Assets = Liabilities + Equity$$

14. The sum of the economic totals for liabilities and equity equals the total economic assets of the entity (that is, both recognised and unrecognised economic resources, included internally generated goodwill measured with current values). However, general purpose financial statements are not designed to show the value of the entity as a whole (as explained in paragraph OB7 of the existing *Conceptual Framework*). Instead, information is provided to help users estimate these amounts. This information can be communicated by various means; however the principal methods are through the process of **recognition and the measurement** of the elements.

15. The processes of recognition and measurement reflects the relationship between the elements in the entity's **economic** financial position and financial performance, however those processes are limited by:

(a) partial recognition. Not all economic resources of the entity (eg internally generated goodwill) and claims against the entity are necessarily recognised in the financial statements. Thus the recognised elements are typically not complete.

(b) mixed measurement of the amounts recognised. The amounts recognised for assets and liabilities are measured using different measurement bases (for example, historical cost or fair value). These mixed measurement requirements result in totals that do not reflect a single measurement objective.

16. The above constraints are significant to the classification effects of claims because the incompleteness of the recognition and measurement of assets and liabilities is 'absorbed' by equity.

17. Based on the definitions of the elements, and the process of recognition and measurement, the distinction between liabilities and equity has the following primary effects in existing IFRS:

(a) **Financial position**—Total recognised liabilities and total recognised equity are distinguished in reporting the entity's financial position.

(b) **Measurement**—The carrying amount of recognised liabilities is updated through subsequent measurement (eg interest accretion, fair value changes) while the carrying amount of total equity is updated to reflect only changes in assets and liabilities.[1]

(c) **Financial Performance**—Recognised changes in in the carrying amount of liabilities (which are part of the *Conceptual Framework* definitions of income and expense) are included in reporting the entity's financial performance while recognised changes in equity are not.

18. In addition, the distinction has resulted in various differences in **disclosure and presentation** requirements in IFRSs. For example, apart from non-controlling interests, equity is typically treated as a large homogeneous class by IFRSs, disregarding important differences between different classes of equity instruments

[1] However there are some requirements for the allocation of total equity to classes and categories, for example in accounting for non-controlling interests.

(even though the Conceptual Framework permits subdividing equity into classes). It is not clear why this is the case, or why financial statements should not provide additional information about equity claims. The only instance where information is provided about the effect of other equity claims on each other is in the calculation of earnings-per-share.

Illustration of perceived conceptual challenges

19. To help illustrate the conceptual challenges with distinguishing between liabilities and equity, we will focus on two particular transactions which have remained unresolved by the Interpretations Committee. We will, of course, explore a number of other transactions throughout the course of this project, including varieties of these transactions.

20. The two transactions are:

    (a) **Put options written on non-controlling interests (NCI puts)**—In summary, these instruments require the entity to repurchase shares in a subsidiary (non-controlling interest shares) in exchange for cash, at the option of the counterparty (the non-controlling interest share holder). For the particular type of NCI put we want to consider in this section, the quantity of cash to be transferred by the entity is equal to the fair value of the underlying shares, and the option is exercisable on demand by the holder in perpetuity.

    (b) **Contingent convertibles bonds (CoCos)**—Of the many varieties, the variety considered by the Interpretations Committee was a claim that pays discretionary interest at the option of the entity and mandatorily converts to a variable number of the entity's own shares if the entity breaches their Tier 1 Capital ratio. The quantity of shares on conversion is equal to the face value of the claim (ie a fixed amount of currency).

21. We can illustrate the perceived conceptual challenges by comparing and contrasting the features and resulting accounting of NCI puts and CoCos to the features and resulting accounting of straight bonds and ordinary shares.

22. For the type of NCI put we describe above, the obligation to transfer cash is similar to the obligation to transfer cash in **a bond**. However, because the amount of cash to be transferred equals the value of the underlying share, the return on the claim (and the risk of that return) is the same as the return on **ordinary shares and different to the return on a bond**.

23. If the obligation to transfer cash in the NCI put were classified as a liability, then it would reflect the similarity with the bond, however changes in the amount of that liability would be included as income or expense. This would not reflect the similarity of those returns with the returns on ordinary shares. In contrast, if the obligation that promises the same return as ordinary shares were classified as equity, then it would reflect the similarity with ordinary shares, but it will not reflect the similarity with the bond ie the obligation to transfer cash.

24. For the type of CoCo we describe above, the variable share settlement feature includes a promised return on the claim which is independent of the performance of the entity (such as fixed amount of currency). This feature is similar to the promised return on a **zero-coupon bond and different to the return on ordinary shares**. However, the lack of any requirement to transfer cash prior to liquidation is similar to **ordinary shares and different to the obligation to transfer cash of the bond**.

25. If the obligation to transfer a variable number of shares were classified as equity, then it would reflect the similarity with ordinary shares: the lack of any obligation to transfer economic resources. However changes in the amount of the claim would be excluded from income or expense. This would not reflect the similarity of the return on the claim with the return on the bond (ie a promised return of a fixed amount). In contrast, if the obligation to transfer a variable number of shares were classified as a liability, then changes in the amount of the claim would be included in income or expense. This would reflect the similarity of the return on the claim with the return on the bond. However it would not reflect the similarity with the ordinary share of the lack of any obligation to transfer economic resources.

26. A single distinction cannot convey all of the similarities and differences between the instruments above. Thus classifying claims as liabilities or equity is not

sufficient enough in isolation to provide useful information about other similarities and differences. The classification will need to be supported with additional requirements for different classes of liabilities and of equity to properly convey those similarities and differences.

27. This is consistent with the IASB's decision in October to consider both:

    (a) improvements to the requirements of IAS 32 for the classification of claims as liabilities or equity; and

    (b) additional presentation and disclosure requirements within liabilities and within equity.

What are the application challenges?

28. A number of application challenges have been identified as a result of submissions to the Interpretations Committee and from other projects. As noted previously, these primarily relate to the consistency, completeness and clarity of the requirements under IAS 32. In particular, these challenges typically arise when accounting for derivatives on own equity. There are also issues with the interaction of IAS 32 with the requirements of other standards, such as IFRS 3 *Business Combinations*, IFRS 10 *Consolidated Financial Statements* and IAS 33 *Earnings-per-share*.

29. Application challenges include, but are not limited to, the following:

    (a) the application of the fixed-for-fixed condition to derivatives on own equity in IAS 32 (in particular for foreign currency convertible bonds).

    (b) the application of the requirement in IAS 32 to recognise a 'gross' liability for derivatives that include an obligation of the entity to purchase its own equity instruments (in particular, when that obligation is conditional or contingent, such as for NCI puts).

    (c) whether IAS 32 applies to features that are introduced through statutory requirements (or regulatory overlays). Some have commented that it can also be difficult to distinguish a contractual obligation from a statutory obligation. This has been raised in the context of mandatory

tender offers (which are similar to NCI puts) and some varieties of CoCos where the conversion feature is introduced by regulations.

(d) how IAS 32 applies to features that are contingent on events beyond the control of the entity and the counterparty. Some have commented that it can also be difficult to distinguish events that are within the control of the issuer, from those that are beyond their control. This has also come up in the context of:

(i) NCI puts—for example where the share is puttable in the event of death of the holder; and

(ii) CoCos—for example when the conversion is contingent on the entity's capital ratio or a regulator's actions.

(e) the lack of guidance in IAS 32 on how to account for transactions within equity. For example, for NCI puts, it is not clear whether the 'reclassification' requirement in paragraph 23 of IAS 32 implies that NCI equity should be derecognised, or whether an 'equity receivable' should be recognised in the NCI component of equity.

(f) the lack of guidance in IAS 32 regarding the classification of discretionary payments made on instruments which are wholly classified as liabilities.

How are users affected by the perceived challenges?

30. Users of the financial statements will be the primary parties that are affected by issues relating to the distinction between liabilities and equity. As noted in the *Conceptual Framework*, users need information in financial statements that will help them assess:

(a) the prospects for future net cash inflows to the entity; and

(b) the return they expect from investing in debt or equity instruments.

31. Consequently, to the extent that various features have an effect on the prospects for future cash flows to the existing or potential investor, then those features are relevant to that existing or potential investors' assessment of those prospects. Thus those features, and the effect of those features, must be faithfully represented

in the financial statements. However, because various types of claims exist with various similarities and differences in their features, it is not possible for a single distinction of those claims, with polarised accounting effects, to faithfully represent all of those similarities and differences. In addition, the effects of some features on the prospects of future cash flows may be more relevant to one aspect of financial reporting than another.

32. If the similarities and differences between claims are not taken into account, then users can make estimation errors regarding the cost of capital and expected return on investments. This is not simply an issue of distinguishing between liabilities and equity, but showing other relevant distinctions **within liabilities** and **within equity**.

33. For example, by not differentiating and disclosing differences in subsets of claims within equity, investors in particular equity instruments may make estimation errors regarding the return on their investment. The absence of information about different claims classified as equity may be the reason why many equity investors responding to previous consultations support a very narrow definition of equity.

34. In addition users are also affected by diversity in practice when implementing the requirements of IAS 32. Application challenges, if unresolved, have the potential to increase diversity in practice. This affects users by reducing the comparability and understandability of financial statements. As noted previously, comparability is difficult to achieve with financial instruments given that similar outcomes can be achieved with various combinations of features.

35. Parties other than the primary users will also be affected by the issues and any changes to the requirements, including:

    (a) Some regulators, as a particular type of user, will have an interest in how an entity's financial position and performance is represented, and the interaction with regulatory requirements.

    (b) Preparers will have an interest in representing their capital structure as faithfully as possible, and limiting the complexity and costs of applying the accounting requirements.

(c) Auditors will have an interest in the auditability of the requirements, how robust the distinction is and the complexity and cost of applying the accounting requirements.

Is the matter more prevalent in some jurisdictions than others?

36. We have previously noted that the characteristics of claims have evolved to meet investors' changing needs. However, capital structures have evolved over time in different ways in different jurisdictions.

37. As jurisdictions adopt IFRSs, there might be claims with new features (or new combinations of features) to which IFRSs will need to be applied for the first time. Also, prior to the introduction of IFRS in a given jurisdiction, the *financial reporting* of capital structures around the world would also have evolved to reflect local varieties, and therefore claims with similar features would have been reported in a variety of ways in different jurisdictions. This history influences the views of respondents and users regarding the desired accounting outcomes for particular types of instruments.

38. Particular regulatory or legal structures may be more common in one jurisdiction than another. For example:

    (a) In many jurisdictions, mandatory tender offers (MTOs) on acquisition of a controlling interest are common regulatory requirements, in which case the issues would be pervasive to takeover transactions in that jurisdiction.

    (b) In other jurisdictions it is quite common (although not a legal requirement) for significant non-controlling interest shareholders to be offered a put option on their shares on an acquisition. These may not be as pervasive as when the requirements are legally required, but for many entities the effect can be acute.

    (c) In many developing economies, foreign currency convertible bonds are frequently issued to access more developed foreign capital markets.

39. Even within existing IFRS jurisdictions, continuing financial innovation, and the introduction of new regulatory requirements after the financial crisis, has

increased the variety of claims to which the requirements of IAS 32 apply. For example:

(a) Changes in tax and/or regulatory requirements may offer incentives for some particular types of transactions.

(b) Changes in economic expectations may make some forms of claims with differing risk and return profiles more attractive. For example, the extremely low returns on high quality bonds following the financial crisis has increased demand for securities with features that increase risk and return.

Which entities are affected by these challenges and to what extent?

40. Given the wide variety of claims and the fundamental nature of the distinction, many different types of entities might be affected.

41. However, some are worth highlighting:

(a) Financial institutions—The introduction of new capital rules by banking regulators has increased the variety and amount of 'bail-in' instruments. The 'CoCos' described above are a form of this new claim.

(b) Non-financial corporates—Non-financial corporates issue 'hybrid' securities for a variety of reasons including capital management, tax and, more recently, investor demands for higher yields. For some of these entities, the issues may be more acute than for others.

(c) Co-operatives—Issues with accounting for members shares in co-operatives led to the issuance of IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments*. We have not identified any perceived challenges with IFRIC 2. However, IFRIC 2 is an interpretation of IAS 32, therefore we will need to consider any implications of changes to IAS 32 for co-operatives.

(d) Some transactions are tailored to a particular entity and its circumstances. Depending on the features of these claims, some of the perceived challenges can be very acute for a small set of entities. For

example, one entity responding to the Interpretation Committee's consultation on NCI puts noted that the value of its NCI put liability in 2011 was around EUR4bn, with changes in the liability representing between 20%-70% of the entity's net profit in the period between 2007 and 2011.

How do we intend to approach the challenges?

42. The IASB has taken the approach of identifying not only which characteristic(s) of claims should be used to distinguish between liabilities and equity, but how other relevant distinctions between claims may be communicated by other means. By doing so, the IASB acknowledges that various relevant characteristics will need to be communicated to the user in some way.

43. Therefore, the starting point will be to identify which characteristics of claims are relevant. These characteristics will provide the foundation for both the potential distinction between liabilities and equity, and the potential subclasses within liabilities and within equity.

44. While the focus of this project is on the challenges in classifying claims with particular types of characteristics under IAS 32, it is important to remember that the classification of the majority of claims has not presented challenges. Indeed, some have commented that, regardless of the challenges identified in this paper, IAS 32 proved to be robust during the recent financial crisis.

45. Therefore, while the objective of this project is to identify a potential solution to any challenges identified, we need to ensure that any potential solution:

    (a) limits unnecessary changes; and

    (b) does not introduce unintended consequences.

46. **For all of the topics below, our starting point will be to consider the question from the point of view of the existing requirements of IAS 32 and, to the extent relevant, other IFRSs.**

47. To address the conceptual challenges, the IASB will need to discuss the following:

(a) The relevant features of claims and the information needs of users:

(i) Which features does IAS 32 consider when classifying instruments as liabilities or equity (including definitions and exceptions)?

(ii) Which features do other IFRSs consider when classifying claims?

(iii) Are there other features of claims which are relevant that are not currently considered? What assessments are those features relevant for?

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

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

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

(e) Do we need to develop the following requirements, or can we borrow existing requirements from other IFRSs (say 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?

48. To address the application challenges of IAS 32, the IASB will need to discuss the following topics:

(a) Discuss 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

(b) Discuss 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.