STAFF PAPER

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Project	**Financial Instruments with Characteristics of Equity research project**
Paper topic	Project status and scope

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Introduction

1. This paper discusses the following:
   (a) What is the status and objective of the project (paragraphs 3 – 11)?
   (b) What is the scope of this project (paragraphs 12 –17)?
   (c) How does this project interact with the Conceptual Framework project (paragraphs 18-22)?
2. This paper is for information only.

What is the status and objective of the project?

3. 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. Those responses included requests for improvements to IAS 32, to the Conceptual Framework or both.
4. 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.

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(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.

5. 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 problems 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 an existing Standard.

6. In considering whether to add a project to the standards-level programme, the IASB requires the development of a specific project proposal. The primary objective of a project proposal is to help the IASB to manage its resources effectively and to help it prioritise its standards-level work. The IASB evaluates the merits of adding a potential item to its standards-level programme primarily on the basis of the needs of users of financial reports, while also taking into account the costs of preparing the information in financial reports. 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.

7. The extent of work required at this stage of Due Process depends on the IASB's assessment of what it requires to make the decision to add a project to its standard-setting programme.

8. In order to develop a specific project proposal (and proceed to the next stage of Due Process), the IASB will have to be satisfied that it has a sufficient information and understanding of the following:

    (a) **Step 1**: that there is a potential problem that can be identified and defined that merits the IASB developing a standards-level solution;

    (b) **Step 2**: the possible approaches to addressing the problem, and their relative costs and benefits, have been identified and defined; and

    (c) **Step 3**: that one of the possible approaches to addressing the problem can be selected and developed into a standards-level solution.

9. Taking each subsequent step is dependent on the IASB's satisfaction that it has sufficient information and understanding of the preceding step. For example, if the IASB is satisfied that it has sufficient information and understanding of the problem, it might also begin assessing potential approaches to solving the problem as part of the research phase of the project. If the IASB is not satisfied that it has sufficient information and understanding of the problem, then it might decide to expose its preliminary analysis of the problem before proceeding further. Generally, ensuring it has sufficiently identified and defined the problem before exploring potential solutions will be more efficient, and will increase the possibility of project success, than exploring potential solutions to an ill-defined problem.

10. Publishing a Discussion Paper, Research Paper or a Request for Information as part of the research stage helps ensure that the IASB has sufficient information and understanding of each of the steps above. Therefore the document published as a result of the research might include the following:

    (a) a preliminary assessment of the problem;

    (b) possible approaches to addressing the problem identified; and

    (c) the preliminary views of the IASB of which possible approach to addressing the problem identified it intends to pursue.

11. Following this process, agenda Paper 5A discusses a preliminary analysis of the challenges presented in applying the requirements of IAS 32, considers these challenges based on the criteria in paragraph 6, and discusses how the staff intend to approach addressing these challenges.

What is the scope of this project?

12. The effects of the distinction between liabilities and equity are fundamental aspects of accounting that can be traced back to definitions of the elements in the *Conceptual Framework*.

13. IAS 32 *Financial Instruments: Presentation* is one of the IFRSs that include requirements for the classification of claims as liabilities or equity. The other IFRS that deals directly with similar classification issues is IFRS 2 *Share-based Payments*. There are also many other IFRSs that contain requirements that interact with IAS 32 in one way or another (see paragraph 16).

14. In October 2014 the IASB decided that this project should investigate potential improvements:

    (a) to the classification of liabilities and equity in IAS 32 *Financial Instruments: Presentation,* including investigating potential amendments to the definitions of liabilities and equity in the *Conceptual Framework*; and

    (b) to the presentation and disclosure requirements for financial instruments with characteristics of equity, irrespective of whether they are classified as liabilities or equity.

15. Given the above decision, the staff’s primary focus will be to research challenges with the classification requirements of IAS 32. Nevertheless, when we are exploring potential solutions to these challenges, we will look at other existing requirements beyond IAS 32 that might be useful. Looking at existing requirements in other standards may help the IASB:

    (a) explore what additional solutions, other than shifting claims between liabilities and equity, are at our disposal to address the challenges we identify.

(b) identify existing solutions in other IFRSs that have a better cost-benefit balance than inventing new solutions.

16. Some requirements in other IFRSs interact with the requirements in IAS 32. These IFRSs include, but are not limited to:

(a) Other financial instruments standards and interpretations:

(i) IFRS 9 *Financial Instruments*

(ii) IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments*

(iii) IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments*.

(iv) IFRIC 17 *Distributions of Non-cash Assets to Owners*.

(b) Performance reporting:

(i) IAS 1 *Presentation of Financial Statements*

(ii) IAS 33 *Earnings per Share*

(c) Business combinations, consolidations and investments in associates and joint ventures:

(i) IFRS 3 *Business Combinations*

(ii) IFRS 10 *Consolidations*

(iii) IAS 28 *Investments in Associates and Joint Ventures*

17. The staff are not researching challenges with other IFRSs. However:

(a) if the outcome of the research project is a recommendation to add a project to amend the *Conceptual Framework*, we will need to consider implications for future revisions to other Standards that might be affected. One of those Standards could be IFRS 2.

(b) we will need to be aware of potential knock-on effects arising from the interactions noted above and we may need to consider consequential amendments to some of these IFRSs as a result of any changes proposed to IAS 32.

How does this project interact with the Conceptual Framework project?

18. Consistently with the IASB's statement in the Agenda Consultation Feedback Statement, the IASB began discussing some of the challenges related to distinguishing liabilities and equity in its Conceptual Framework project. Therefore, this research project interacts with the IASB's Conceptual Framework project and follows on from the discussion of the issues in the Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* and the feedback received on those views.

19. During redeliberations of the Conceptual Framework project, the IASB tentatively decided:

    (a) that the *Conceptual Framework* should continue to make a binary distinction between liability and equity claims against an entity; and

    (b) that the definitions of a liability and of equity should be further developed building on the feedback received on the Discussion Paper.

20. However, the IASB was unable to reach a conclusion on the distinction between liabilities and equity in the Conceptual Framework project and decided to further explore how to distinguish liabilities from equity claims in this research project.

21. An Exposure Draft for the revised *Conceptual Framework* is due to be published shortly. The upcoming Exposure Draft for the *Conceptual Framework* will include proposed changes to the definition of a liability and will <u>not</u> include any proposed changes to the existing definition of equity. Those proposed changes address problems with the application of the definition to uncertain or conditional liabilities. Those proposed changes do not address challenges relating to the application of the definition to distinguishing liabilities from equity. These challenges will be explored as part of this research project. The research project <u>will not be</u> constrained by the proposed definitions in the *Conceptual Framework* ED.

22. The IASB observed that one possible outcome of the research could be a recommendation to propose an amendment to the Conceptual Framework in relation to distinguishing between liabilities and equity. Thus, an outcome of the research may include a proposal to add a project to amend the Conceptual

Framework, in addition to a proposal to add a project to amend or replace IAS 32. Nevertheless, any such changes are unlikely to reverse the clarifications to be suggested in the Exposure Draft for the Conceptual Framework.