STAFF PAPER

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Project	Financial Instruments with Characteristics of Equity research project
Paper topic	Analysis of IAS 32 and outline of potential approaches

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Introduction

1. The objective of this paper is to:

   (a) analyse the existing definitions and other related requirements in IAS 32 *Financial Instruments: Presentation*, and identify:

      (i) to what extent those requirements capture the features needed to make the assessments we identified in July 2015; and

      (ii) whether there are exceptions, inconsistencies, and gaps in those requirements.

   (b) outline possible approaches for improvements that we intend to develop further as the project progresses.

2. This paper focuses on the classification of non-derivatives, we will expand the analysis to derivatives at a future meeting.

3. This paper is structured as follows:

   (a) Background (paragraphs 4–9)

   (b) Analysis of the existing definitions of IAS 32 (paragraphs 10–61)

   (c) Potential approaches for improvements (paragraphs 62–87)

   (d) Appendix A: Relevant text of IAS 32

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Background

What are the relevant features of claims?

4. In June 2015 (Agenda Paper 5A) we discussed:

   (a) the features of claims against an entity and what makes information about a particular feature relevant to users. In particular, we stated that a feature is relevant if it could affect the amount, timing and uncertainty of (the prospects for) future cash flows.

   (b) how information about relevant features is provided in financial statements. In particular we stated that to depict a feature, it must be measured and noted that there must be at least one claim that will be measured as a residual, because of partial recognition and mixed measurement.

   (c) the features that we identified as being relevant are:

      (i) the **type** of economic resource required to be transferred to settle the claim (eg cash, goods or services etc);

      (ii) the **timing** of the transfer of economic resources required to settle the claim (eg specified dates, on demand or at liquidation);

      (iii) the **amount (or quantity)** of economic resources required to be transferred (eg currency units, commodity units, formulas or rates of change, or a share of the net assets of the entity);

      (iv) the **priority (or seniority/rank)** of the claim relative to other claims (eg senior, junior or most subordinate).

5. We also stated that different features affect the prospects for future cash flows in different ways, and information about those effects may influence different types of assessments that users need to make. Those differences may require:

   (a) different recognition requirements or measurement bases;

   (b) the inclusion of the amounts measured in different totals and sub-totals in the statement of financial position and statements of performance;

(c) additional information about those features to be disclosed in the notes to the financial statements.

What features are relevant for the entity's financial position and financial performance?

6. In July 2015 (Agenda Paper 5A), we discussed the relevance of the features we identified to:

    (a) assessments of financial position:

        (i) **Assessment A**: The extent to which the entity is expected to have the economic resources required to meet its obligations *as and when* they fall due.

        For this assessment, users need information about the **timing** of required settlement of claims.

        If that **timing** is **prior to liquidation** (eg specified dates), then the **amount** and **type** of economic resources that the claim requires the entity to transfer will also be relevant.

        (ii) **Assessment B**: The extent to which an entity has sufficient economic resources to satisfy the total claims against the entity *at a point in time* and how any potential shortfall will be distributed amongst claims.

        For this assessment, users need information about the **amount** of economic resources required to settle the claim at that point in time.

        If that **amount** is **independent** of the availability of the entity's actual economic resources (eg a specified amount of currency units), then the **priority** of the claim on liquidation will also be relevant.

    (b) assessments of financial performance:

        (i) **Assessment Y**: The extent to which the entity has produced a sufficient return on its economic resources to satisfy the promised return on claims against it and to determine how any potential shortfall in returns will be distributed amongst claims.

For this assessment, users need information about changes in the **amount** of resources required to settle the claim[1].

If that **amount** is independent of the entity's actual economic resources (eg a fixed interest return), then the **priority** of the claim on liquidation will also be relevant.

(ii) **Assessment X**: The returns that an entity has produced on its economic resources.

For this assessment, users need information about changes in its economic resources.

The **timing** of settlement and **type** of economic resources required to settle claims may have implications for the entity's economic resources. However those changes will be recognised as they occur in accordance with requirements for the entity's assets.[2] These features may be relevant to assess physical flows, such as contributions and distributions, for which information is provided elsewhere, such as in the statement of cash flows.

7. As we noted in July, Assessment Y is a comparison of the returns on the entity's economic resources to the promised returns on the claims on the entity. If the specified amount of all of the claims on an entity depends solely on the performance of the entity's economic resources (for example, a fully ordinary share funded entity) then no further information is required other than information about the performance of the entity's economic resources. It is only when claims are introduced that specify an amount different to, or independent of, the entity's total economic resources that information about those changes is required to satisfy Assessment Y. Only then will the returns on claims differ from the returns on the entity's economic resources.

[1] How the specified amount changes over time is the promised return. For example, the amount could be a contractually specified fixed amount which does not change, or it could change based on a formula such as an interest rate, index rate or underlying asset price.

[2] Given that an entity's financial performance includes changes other than contributions and distributions to claim holders, the **timing** of required settlement and **type** of resource required, are features that determine *when* the distributions of resources will occur, and **what** form that distribution will take. These changes may be relevant for assessing the entity's financial performance as reflected by cash flows (OB20)

Instruments used for illustrations

8. We will use the same instruments that we used at the June and July 2015 meetings to illustrate matters in this paper, namely:

    (a) **Ordinary shares**—A claim that contains no obligation of the entity, other than the obligation to transfer at liquidation a share of whatever type, and amount, of economic resources remain under the entity's control after meeting all other claims. If the entity distributes dividends, the distribution is shared equally.

    (b) **Ordinary bonds**—A claim that contains an obligation of the entity to transfer cash, equal to an amount specified in a particular currency, at a specified time prior to liquidation.

    (c) **Shares redeemable for their fair value**—A claim with equivalent features to an ordinary share, *except* that the entity has the obligation to settle the claim, at fair value in cash, on demand of the holder.

    (d) **Share-settled bonds**—A claim with equivalent features to an ordinary bond, *except* that the entity has to settle the claim using a variable number of its own ordinary shares of an equal value to the amount specified. We assume that the entity has the ability to issue a variable number of shares to settle such a claim in all circumstances.

    (e) **Cumulative preference shares**—A claim with equivalent features to an ordinary bond in which the amount specified increases over time, *except* that the entity is *not* obliged to settle the claim in part, or in full, prior to liquidation.

9. As a reminder, we selected the above instruments to serve as simplified examples that share some features of more complex instruments that we identified as troublesome in May 2015 (Agenda Paper 5A). These included:

    (a) Put options written on non-controlling interests (NCI puts)

    (b) Contingent convertibles bonds (CoCos)

    (c) Redeemable preference shares with dividend step-up features.

Analysis of the existing definitions in IAS 32

10. In this section, we analyse the existing definitions and other related requirements in IAS 32, and identify:

    (a) to what extent those requirements capture the features needed to make the assessments we identified in July 2015; and

    (b) whether there are exceptions, inconsistencies, and gaps in those requirements.

11. We have reproduced the relevant text of the definitions of IAS 32, together with any relevant supporting paragraphs, in Appendix A.

12. IAS 32 has two main principles for classifying *non-derivative* financial instruments as financial liabilities:

    (a) Obligations to deliver cash or another financial asset (paragraphs 16–37)

    (b) Obligations to deliver a variable number of equity instruments (paragraphs 38–49)

13. For convenience, we have split our analysis based on the above principles.

14. It should be noted that IAS 32 does not have independent definitions of income and expense. IFRS 9 requires all gains and losses on financial liabilities to be recognised in either profit or loss or other comprehensive income. Thus, consistently with the Conceptual Framework, whether a change in a claim meets the definition of income and expense depends on whether the claim meets the definition of a financial liability.

15. We summarise the analysis in paragraphs 50–61.

Obligation to deliver cash or another financial asset

16. The definition of a financial liability in IAS 32 includes financial instruments with a contractual obligation to **deliver cash or another financial asset** to another entity. This includes only such obligations if the transfer is required **prior to liquidation**.

17. Using the features we have identified, we can analyse this definition as follows:

    (a) the cash or another financial asset represents the **type** of economic resource that is required to be transferred.

    (b) the requirement to deliver economic resources prior to liquidation represents the **timing** of the required transfer.

18. The requirement to transfer cash or another financial asset is what makes the claim a *financial* liability. IAS 32 and IFRS 9 *Financial Instruments* have requirements for financial liabilities. Other IFRS include requirements for obligations to transfer other types of economic resources. For example:

    (a) IFRS 15 *Revenue from Contracts with Customers* applies to obligations to transfer goods and services; and

    (b) IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* applies to obligations to transfer economic resources which are not within the scope of any other IFRS.

19. In each of the IFRS in the preceding paragraph, the type of economic resource to be transferred, among other characteristics of the obligation (such as the amount), is used as the basis for sub-classifications of different liabilities. These sub-classifications result in different requirements, such as recognition and measurement, through the scope requirements of these different IFRS.

20. However, consistently with the Exposure Draft *Conceptual Framework for Financial Reporting* (the CF ED), each obligation is a liability only if there is an obligation to transfer that economic resource prior to liquidation. Therefore, we can conclude that the part of the definition that is relevant for distinguishing between liabilities and equity is the **timing** of the required transfer.

21. IAS 32, and the CF ED, classify claims with such a feature as liabilities regardless of any other features the claim may have that are relevant. As noted in BC8 of the discussion of puttable instruments in IAS 32 [emphasis added]:

    > The classification [of a puttable instrument] as a financial liability is independent of considerations such as when the right is exercisable, *how the amount payable or receivable upon exercise of the right is determined*, and whether the puttable instrument has a fixed maturity.

22. As mentioned in paragraph 6(a)(i), information about claims with an obligation to deliver economic resources prior to liquidation is relevant to Assessment A. Also, for claims that require settlement prior to liquidation, the amount and type of economic resources required to be transferred are also relevant for Assessment A.

23. However, IAS 32 also has exceptions to this general principle. In 2008, the IASB introduced an exception to the definition of a liability for some puttable financial instruments. That exception results in the classification of some obligations to transfer economic resources prior to liquidation as equity instead of liabilities.

24. To summarise some complex and detailed requirements (replicated in full in Appendix A), this exception applies to puttable financial instruments that:

    (a) are the most subordinate claim on liquidation of the entity (or are not equally subordinate with other claims that do not share all the same features); and

    (b) oblige the entity to deliver a pro rata share of the entity's net assets[3] to the holders on liquidation, or an amount broadly equivalent to the fair value of such a claim on early redemption.

25. Using the features we have identified we can analyse this exception as follows:

    (a) The most subordinate claim on liquidation represents the claim's **priority**; and

    (b) The pro rata share of the entity's net assets, or of its fair value, represents the **amount** of economic resources required to be transferred to settle the claim.

26. The Basis for Conclusions on IAS 32 (paragraph BC50) includes a description of the concerns that would have arisen from classifying puttable instruments with the above features as liabilities. Some of those concerns relate to the entity's financial performance and are discussed in paragraphs 33-35. Other concerns related to problems that arise because of the incomplete recognition and measurement of assets and liabilities. These concerns included that:

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[3] The entity's net assets are those assets that remain after deducting all other claims on its assets

(a) on an ongoing basis, the liability would be recognised at not less than the amount payable on demand. This could result in the entire market capitalisation of the entity being recognised as a liability, depending on the basis for calculating the redemption value of the financial instrument.

(b) it is possible, again depending on the basis for calculating the redemption value, that the entity would report negative net assets because of unrecognised intangible assets and goodwill, and because the measurement of recognised assets and liabilities may not be at fair value.

27. Both the existing and proposed Conceptual Framework note that, unless all assets and liabilities are recognized and measured at a current value, there is a possibility that total equity will be negative. Also, the incomplete recognition and measurement of assets and liabilities means that at least one claim will have be recognized and measured as a residual.

28. If all of the entity's claims include an obligation to transfer economic resources prior to liquidation, then, without the exception, the entity would have no claims that meet the definition of equity. The absence of a claim that meets the definition of equity causes a number of problems because:

(a) equity is typically the element that is measured as a residual.

(b) the definitions of income and expense assume the existence of equity (a change in an asset or liability needs to result in an increase in equity to meet the definition of income and expense).

29. As mentioned in paragraphs 6(a)(ii) and 6(b)(i) the **amount** of resources required to settle the claim, and the **priority** of the claim on liquidation, are relevant to Assessments B and Y. In particular, distinguishing claims for an amount independent of the entity's economic resources from other claims will be relevant to those assessments.

30. In the case of the puttables exception, the features in paragraph 24 override the fact that the entity will be required to transfer economic resources prior to

liquidation. Claims with these features are classified as equity and are recognized and measured as a residual.

31. And so, even though the claims have a feature that is relevant to Assessment A, the claims classified as equity under the puttable exception would *not* include features that would be relevant to Assessment B and Y. This is because the amount of economic resources required to settle the claim is not independent of the entity's economic resources.

32. However, the claims need to have **both** of the features in paragraph 24 to meet the conditions of the puttables exception. This means that a share redeemable for its fair value would be classified as a liability if there is another claim that is more subordinate.

33. Another of the concerns that led to the puttables exception was that, if such instruments were classified as liabilities, then changes in the carrying amount of the liability would be recognised in profit or loss. This would result in counterintuitive accounting (if the redemption value is linked to the performance of the entity) because:

    (a) when an entity performs well, the present value of the settlement amount of the liabilities increases, and a loss would be recognised; and

    (b) when the entity performs poorly, the present value of the settlement amount of the liability decreases, and a gain would be recognised.

34. These concerns would still apply to puttable shares if they are not the most residual claim, including NCI puts. It also echoes those concerns expressed:

    (a) in response to the May 2012 draft Interpretation on the accounting for NCI puts.

    (b) regarding the relevance of information about changes in the credit risk component of a liability measured at fair value.

35. The arguments above are also similar to our analysis of what changes are relevant to Assessment Y of the entity's financial performance. For Assessment Y, changes in claims are relevant if they are independent of the returns on the entity's recognised and unrecognised economic resources.

36. From the above analysis, we can see that IAS 32 distinguishes between liabilities and equity based on the **timing** of required settlement. In particular, it classifies as liabilities claims that require the entity to transfer economic resources prior to liquidation, which is relevant for Assessment A. However, in some circumstances, it also classifies claims with that feature as equity based on the **amount** of resources required to settle the claim and the **priority** of the claim on liquidation (the puttables exception).

37. Apart from the puttables exception, IAS 32 does not distinguish between:

    (a) Claims that require the transfer of economic resources prior to liquidation of an amount independent of the entity's economic resources (eg **ordinary bonds**); and

    (b) Claims that require the transfer of economic resources prior to liquidation that are not independent of the entity's economic resources (eg **shares redeemable for fair value that are not the most residual claim**).

Obligation to deliver a variable number of equity instruments

38. The definition of a financial liability in IAS 32 includes financial instruments with a contractual obligation to **deliver a variable number of equity instruments** (eg **share-settled debt**).

39. The Basis for Conclusions on IAS 32 explains that the IASB included such obligations in the definition of a financial liability for the following reasons:

    (a) the entity has an obligation for a specified amount rather than a specified equity interest. For such a contract, the entity does not know, before the transaction is settled, how many of its own shares (or how much cash) it will receive or deliver and it may not even know whether it will receive its own shares or deliver them.

    (b) precluding equity treatment for such a contract limits incentives for structuring potentially favourable or unfavourable transactions to obtain equity treatment. For example, the IASB believed that an entity should not obtain equity treatment for a transaction simply by including a share

settlement clause when the contract is for a specified value, rather than for a specified equity interest.

40. From the reasoning in paragraph 39 it is clear that the IASB did not think that simply substituting the requirement to transfer economic resources with a requirement to deliver a variable number of shares (ie using its own equity instruments as currency) should result in a difference in the reporting of the changes in such a claim. This is further reinforced in paragraph BC15, in which the IASB rejected the argument that a contract that is settled in the entity's own shares must be an equity instrument because no change in assets or liabilities, and thus no income or expense, arises on settlement of the contract. The IASB noted that any income or expense arises before settlement of the transaction, not when it is settled.

41. Based on the above, in our view the feature the IASB was attempting to capture was an obligation for a specified **amount** independent of the entity's economic resources. Similar to the puttable exception, this feature overrides the fact that the entity *will not* be required to transfer economic resources prior to liquidation.

42. As mentioned in paragraphs 6(a)(ii) and 6(b)(i) distinguishing claims for an amount independent of the entity's economic resources from other claims will be relevant to Assessments B and Y. Because the obligation is to transfer its own ordinary shares, the entity has no obligation to transfer its economic resources prior to liquidation. Therefore the information about these claims is not relevant for Assessment A.

43. Similar to obligations to transfer a variable number of shares, other claims against the entity also have an obligation for a specified amount, and do not require the entity to transfer economic resources prior to liquidation (eg **cumulative preference shares**). However, because such claims do not require the entity to deliver equity instruments, they are not classified as financial liabilities.

44. This could be the case because, the amendments made to IAS 32 that introduced the variable share settlement requirements were part of a limited scope improvements project. That project focused on instruments settled with, or indexed to, an entity's own equity. The IASB was not considering in that project other types of instruments or other issues with the distinction between liabilities

and equity. Hence, the omission of other instruments that specify an amount could simply be a consequence of the scope of the project to improve IAS 32.

45. Some might argue that the IASB was motivated to provide information that will help Assessment A (ie identifying those claims that require a transfer of economic resources prior to liquidation). For example, obligations to deliver a variable number of shares might just be a case where the entity is more likely to meet the obligation by transferring economic resources prior to liquidation. However, we do not think that the inclusion of obligations to deliver a variable number of ordinary shares would necessarily provide information for Assessment A, as it would not distinguish between:

    (a) cases where the entity has the ability to deliver a variable number of equity instruments; and

    (b) cases where the entity *does not* have the ability to deliver equity instruments.

46. The entity might not be able to deliver its own equity instruments for a number of reasons unrelated to whether the obligation is for a fixed or variable number of equity instruments. These reasons could include, for example, limitations of the entity's constitution, authorized capital or other legal or regulatory restrictions that limit share issuance. In such situations the entity may be forced to purchase shares on the market to meet its obligation, or otherwise settle its obligation by transferring economic resources. Information about these claims in these cases would be relevant for the purpose of Assessment A.

47. In the staff's view, if the objective was to classify a claim that will require the transfer of economic resources prior to liquidation, then the principle for variable share settlement is unnecessary. Therefore, including the variable share principle was more likely driven by the desire to distinguish claims for an amount independent of the entity's economic resources from other claims.

48. From the above analysis, we can see that IAS 32 also distinguishes between liabilities and equity based on the amount of required settlement. It classifies as liabilities claims that require the entity to transfer a variable number of equity instruments, which is relevant for Assessments B and Y.

49. However, apart from the limited case where the claim is settled by the delivery of an entity's own equity instruments (**eg share settled debt**) IAS 32 does not consistently distinguish between:

    (a) Claims that require the transfer of economic resources at liquidation of an amount independent of the entity's economic resources (eg **cumulative preference shares**); and

    (b) Other claims that require the transfer of economic resources at liquidation that are not independent of the entity's economic resources (eg **ordinary shares**).

Summary of analysis

50. This section includes a summary of the preceding analysis, arranged by the assessments we identified in paragraph 6.

Assessment A

51. Assessment A is the extent to which the entity is expected to have the economic resources required to meet its obligations **as and when** they fall due. Information about claims with an obligation to deliver economic resources **prior to liquidation** is relevant to Assessment A.

52. IAS 32 classifies obligations to transfer cash and other financial assets **prior to liquidation** as liabilities.

53. However, as an exception, IAS 32 classifies obligations that have such a feature as equity if:

    (a) they are **the most subordinate** claim against the entity; and

    (b) the **amount** of cash or other financial assets to be transferred is equal to the recognized and unrecognized net assets of the entity over the life of the instrument.

54. Recognising and measuring a claim as a residual means that the information provided about that claim is limited. Therefore, to the extent that the claim has features that are relevant to Assessment A, information about those features will have to be provided through disclosure.

55. The IASB acknowledged the importance of providing information to users regarding the requirement to transfer economic resources prior to liquidation. Therefore, IAS 1 *Presentation of Financial Statements* requires additional disclosures for claims that meet the puttables exception (paragraph 136A), including:

    (a) summary quantitative data about the amount classified as equity;

    (b) its objective, policies and processes for managing its obligation to repurchase or redeem the instruments when required to do so by the instrument holders, including any changes from the previous period;

    (c) the expected cash outflow on redemption or repurchase of that class of financial instruments; and

    (d) information about how the expected cash outflow on redemption or repurchase was determined.

Assessment B and Y

56. Assessment B is the extent to which an entity has sufficient economic resources to satisfy the total claims against the entity **at a point in time.** Assessment Y is the extent to which the entity has produced a sufficient return on its economic resources to satisfy the promised return on claims against it. For Assessments B and Y, users need information the **amount** of economic resources required to settle the claim, and changes in that amount. In particular, they need to know if that **amount** is independent of the entity's actual economic resources.

57. IAS 32 classifies obligations to transfer economic resources *prior to liquidation* as equity if the **amount** depends on the availability of the entity's economic resources, *and* the **priority** of the claim is the most subordinate claim (the puttables exception).

58. However, IAS 32 classifies other obligations to transfer economic resources *prior to liquidation* as liabilities even if the **amount** depends on the availability of the entity's economic resources. These obligations are:

    (a) accounted for differently from those that meet the puttables exception.

(b) are not distinguished from other claims classified as liabilities that do specify an amount independent of the entity's economic resources.

59. IAS 32 classifies some obligations to transfer an **amount** independent of an entity's economic resources as liabilities *only if* they require the transfer of the entity's own equity instruments prior to liquidation (eg **share-settled debt**)

60. However, IAS 32 classifies other obligations to transfer an amount independent of an entity's economic resources *at liquidation* as equity. These obligations are:

(a) accounted for differently from those that are settled by delivery of equity instruments.

(b) are not distinguished from other claims classified as equity that do not specify an amount independent of an entity's economic resources.

61. For such obligations classified as equity (eg **cumulative preference shares**), there is a requirement under IAS 33 *Earnings-per-share* to calculate the effect for the purpose of disclosing earnings per share. However that effect is not presented in the statement of financial performance together with changes in obligations to deliver a variable number of shares. Nor does that disclosure assist in providing information in the statement of financial position for Assessment B.

Question for the IASB
Do you agree with our analysis of the existing definitions and related requirements, of IAS 32?

Possible ways forward

62. In this section, we outline some possible approaches for improvements that we intend to develop further as the project progresses. As noted in previous meetings, the development of these approaches may result in changes to the existing definitions in IAS 32, the framework or both. In particular, we need to identify:

(a) whether changes are required to those definitions and additional guidance to better express the underlying rationale and make them more robust; and

(b) whether additional subclasses within liabilities or within equity are required to help make the identified assessments.

63. Please note that the following approaches present initial ideas and have not been fully developed. In particular, we will have to consider the application of the approaches to derivatives on own equity.

64. We identified three possible approaches:

(a) **Approach Alpha**—Focus the distinction between liabilities and equity on features that are relevant to Assessment A (paragraphs 65–71).

(b) **Approach Beta—**Focus the distinction between liabilities and equity on features that are relevant for Assessments B and Y (paragraphs 72–78).

(c) **Approach Gamma**—Focus the distinction between liabilities and equity on features that are relevant for Assessment A and Assessments B and Y (paragraphs 79–87).

Outline of potential approaches

Approach Alpha

65. Approach Alpha focuses the distinction between liabilities and equity on the **timing** of required settlement, which is relevant to Assessment A. Approach Alpha will classify as liabilities obligations to transfer economic resources **prior to liquidation**. All other claims will be classified as equity.

66. Under this approach, other distinctions within liabilities and within equity will need to be used to provide information for Assessments B and Y. For example, **share-settled debt** and **cumulative preference** shares might be classified as a separate class of equity on the statement of financial position. The carrying amount might also be updated within equity.

67. Approach Alpha will be most consistent with the proposed definition of a liability in the Conceptual Framework ED. However, it will represent a change to IAS 32 with respect to obligations to deliver a variable number of own equity instruments.

68. One of the main consequences of the distinction between liabilities and equity is that changes in liabilities are recognised in profit or loss or other comprehensive income. We have concluded that the features that are relevant for Assessment A are not relevant for Assessment Y. This shortcoming cannot be easily corrected:

    (a) Consistently with the Conceptual Framework, whether a change in a claim meets the definition of income and expense depends on whether the claim meets the definition of a financial liability.

    (b) We have a mechanism to take changes outside profit or loss if we think they are not relevant to Assessment Y. For example, under this approach we could explore the use of OCI to present changes in chares redeemable for their fair value. However, we do not (currently) have a mechanism to include changes in equity claims within profit or loss or OCI.

69. Additional information about changes could be provided using subclasses of equity. We could also explore presenting those changes on the face of the statements of financial performance similar to the attribution of profit or loss and OCI to non-controlling interests and parent equity interests. However, similar changes in claims would be presented in different parts of the performance statement (for example, the fixed return promised on ordinary bonds will be presented separate from the fixed return on share-settled debt and cumulative preference shares). This will make it difficult to make Assessment Y, and it is not clear whether distinguishing changes based on features relevant for Assessment B will be relevant for any particular assessment of performance.

70. As we noted in our analysis in paragraph 28, it is possible for all claims against the entity to have the feature that requires settlement prior to liquidation. Therefore, under this approach, the IASB would likely need to have an exception for the most residual claim similar to the existing puttables exception for the same reasons set out in that paragraph.

71. As a reminder, the 2013 Discussion Paper *A review of the Conceptual framework for Financial Reporting* suggested that in some cases, as an exception, the most residual class of claim should be classified as equity, even if it meets the proposed definition of a liability. However, some respondents to that suggestion stated that:

(a) if the IASB thinks these instruments are more faithfully represented as equity, then that indicates that the definitions are not fit for purpose.

(b) the IASB should improve the definition instead of introducing exceptions at the conceptual level.

Approach Beta

72. Approach Beta focuses the distinction between liabilities and equity on the **amount** of economic resources required to settle the claim, which is relevant to Assessments B and Y. Approach Beta will classify as liabilities obligations to transfer an **amount of economic resources independent** of the entity's economic resources. All other claims will be classified as equity.

73. Under this approach, other distinctions within liabilities and within equity will need to be used to provide information for Assessment A. For example, **shares redeemable at their fair value** might be classified as a separate class of equity on the statement of financial position. The carrying amount might also be updated within equity.

74. Approach Beta would be the least consistent with the the proposed definition of a liability in the Conceptual Framework ED. This approach will require significant changes to the definitions in both IAS 32 and the CF. It will also require a substantial shift in thinking, and may not be immediately intuitive.

75. However, most obligations to transfer an amount independent of the entity's economic resources also include an obligation to transfer an economic resources prior to liquidation. Thus, it will affect the classification of:

(a) Obligations to transfer economic resources *prior to liquidation* of an amount dependent on the entity's economic resources (eg shares redeemable for their fair value). Such claims would be classified as equity under this approach regardless of whether they are also the most residual claim. Another way to look at this is as an expansion of the puttables exception in existing IAS 32.

(b) Obligations to transfer economic resources *at liquidation* of an amount independent of the entity's economic resources (eg cumulative preference shares). Such claims would be classified as liabilities under

this approach regardless of whether they require settlement prior to liquidation or not. Another way to look at this is as an expansion of the variable share settlement principle in the existing IAS 32.

76. Approach Beta addresses both a financial position assessment, and a financial performance assessment. Importantly it would present similar types of changes in claims together for the purpose of Assessment Y.

77. Under Approach Beta, Assessment A can be addressed through additional sub-classifications or categories on the face of the statement of financial position. These sub-classifications would not have consequences for the performance statement and therefore would be easier to implement. For example:

(a) **shares redeemable for their fair value** could presented prominently on the statement of financial position, and the carrying amount updated within equity without affecting how the entity's performance is reported; and

(b) **cumulative preference shares** could be presented as a non-current liability.[4]

78. Approach Beta is also the only approach which would eliminate the need for an exception for some puttable instruments. This is because claims that meet the existing conditions of the exception will be classified as equity under this approach.

Approach Gamma

79. Approach Gamma focuses the distinction between liabilities and equity on both the **timing** of required settlement and the **amount** of economic resources required to settle the claim, which are relevant to Assessment A and Assessments B and Y respectively.

80. Approach Gamma will classify as a liability obligations to transfer:

(a) economic resources **prior to liquidation**; or

[4] or perhaps a new category indicating that the entity can avoid a cash outflow until liquidation

(b) an **amount of economic resources independent** of the entity’s economic resources.

81. All other claims will be classified as equity. Thus, Approach Gamma will only classify as equity claims that:

(a) require the transfer of economic resources only at liquidation; and

(b) the amount of economic resources required to be transferred at liquidation is not independent of the entity’s economic resources.

82. Under this approach, other distinctions within liabilities will need to be used to provide information for the various assessments. No claims that contain features that are relevant for any of the assessments identified would be classified as equity.

83. Approach Gamma is the approach that will be most consistent with where IAS 32 is today. However, changing the focus from the settlement by delivery of a variable number of equity instruments to the amount of resources required to settle an obligation, may affect the classification of some obligations to transfer economic resources at liquidation. It would also imply that the definition of a liability in the CF ED will need to be expanded to include other features.

84. Similar to Approach Alpha it is possible for all claims against the entity to be classified as liabilities. Therefore, Approach Gamma will share some of the associated difficulties that arise because of that, therefore an exception for puttable instruments may still be required.

85. As we stated in May 2015, 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. 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.

86. Importantly, under this approach, claims classified as equity will not have features that are relevant to *any* of the assessments we identified, limiting the need to introduce changes to the requirements for equity to communicate additional information.

87. Thus, under this approach, the IASB would have to develop additional sub-classifications within liabilities to present the effects of the various features of claims and changes in claims. This may be easier to do than for other approaches given that:

    (a) we have a mechanism to take changes outside profit or loss if we think they are not relevant for Assessment Y.

    (b) we also have existing sub-classifications of liabilities within the statement of financial position (eg the current/non-current classification under IAS 1).

Question for the IASB
Do you have any comments on the potential approaches that we have identified and intend to develop further?

Appendix A: Relevant text of IAS 32 and IFRS 9

A1. IAS 32 defines a **financial liability** and an **equity instrument** as follows (paragraph 11):

A **financial liability** is any liability that is

(c) a contractual obligation

(i) to deliver cash or another financial asset to another entity; or

(ii) [*contracts for the exchange of financial instruments will be discussed together with derivatives at a later meeting*]; or

(d) a contract that will or may be settled in the entity's own equity instruments and is:

(i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

(ii) [*derivatives will be discussed at a later meeting*].

As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D.

An **equity instrument** is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

A **puttable instrument** is a financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial assert or is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder.

Note: paragraphs 16A and 16B on puttable instruments are reproduced below. Paragraphs 16C and 16D apply to instruments that include an obligation for the entity to deliver a pro-rata share of its assets only on liquidation, but liquidation is either certain to occur (eg limited-life entities) or is at the option of the instrument holder. We have not reproduced 16C and 16D however they are substantially the same as 16A and 16B except for the omission of paragraphs 16A(d) and (e)

A2. Paragraph 16A:

A puttable financial instrument includes a contractual obligation for the issuer to repurchase or redeem that instrument for cash or another financial asset on exercise of the put. As an exception to the definition of a financial liability, an instrument that includes such an obligation is classified as an equity instrument if it has all the following features:

(e) It entitles the holder to a pro rata share of the entity's net assets in the event of the entity's liquidation. The entity's net assets are those assets that remain after deducting all other claims on its assets. A pro rata share is determined by:

(i) dividing the entity's net assets on liquidation into units of equal amount; and

(ii) multiplying that amount by the number of the units held by the financial instrument holder.

(f) The instrument is in the class of instruments that is subordinate to all other classes of instruments. To be in such a class the instrument:

(i) has no priority over other claims to the assets of the entity on liquidation, and

(ii) does not need to be converted into another instrument before it is in the class of instruments that is subordinate to all other classes of instruments.

(g) All financial instruments in the class of instruments that is subordinate to all other classes of instruments have identical features. For example, they must all be puttable, and the formula or other method used to calculate the repurchase or redemption price is the same for all instruments in that class.

(h) Apart from the contractual obligation for the issuer to repurchase or redeem the instrument for cash or another financial asset, the instrument does not include any contractual obligation to deliver cash or another financial asset to another entity, or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity, and it is not a contract that will or

may be settled in the entity's own equity instruments as set out in subparagraph (b) of the definition of a financial liability.

(i) The total expected cash flows attributable to the instrument over the life of the instrument are based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity over the life of the instrument (excluding any effects of the instrument).

A3. Paragraph 16B

For an instrument to be classified as an equity instrument, in addition to the instrument having all the above features, the issuer must have no other financial instrument or contract that has:

(j) total cash flows based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity (excluding any effects of such instrument or contract) and

(k) the effect of substantially restricting or fixing the residual return to the puttable instrument holders.

For the purposes of applying this condition, the entity shall not consider non-financial contracts with a holder of an instrument described in paragraph 16A that have contractual terms and conditions that are similar to the contractual terms and conditions of an equivalent contract that might occur between a non-instrument holder and the issuing entity. If the entity cannot determine that this condition is met, it shall not classify the puttable instrument as an equity instrument.

A4. IAS 32 does not contain definitions of income and expense. However paragraph 5.7.1 of IFRS 9 requires a gain or loss on a … financial liability that is measured at fair value shall be recognized in profit or loss unless:

(l) …

(m) …

(n) it is a financial liability designated as at fair value through profit or loss and the entity is required to present the effects of changes in the

liability's credit risk in other comprehensive income in accordance with paragraph 5.7.7.

A5. Paragraph 5.7.7 states that, an entity shall present a gain or loss on a financial liability designated as at fair value through profit or loss as follows:

(o) The amount of change in the fair value of the financial liability that is attributable to changes in the credit risk of that liability shall be presented in other comprehensive income; and

(p) The remaining amount of change in the fair value of the liability shall be presented in profit or loss.