IFRS

STAFF PAPER

7 – 8 April 2016

Accounting Standards Advisory Forum

Project	**Financial Instruments with Characteristics of Equity research project**		
Paper topic	Project status and next steps		
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Introduction

1. The objective of this session is to provide the ASAF with an update on progress in the Financial Instruments with Characteristics of Equity research project, and discuss the plan for future deliberations and outreach.

2. This paper includes:

   (a) Background (paragraphs 3–8)

   (b) Summary of discussions since March 2015 (paragraphs 9–32)

   (c) Next steps (paragraphs 33–36)

   (d) Appendix A—Detailed summary of previous discussions with ASAF

   (e) Appendix B—Summary table of the approaches being developed, including the features they are based on and the assessments they intend to facilitate

   (f) Appendix C—Summary table of the classification consequences for some simple instruments

Background

3. The objective of this project is to investigate perceived financial reporting challenges with IAS 32 and to assess potential ways to improve financial

reporting and/or to remedy an identified deficiency. That work will help the International Accounting Standards Board (the Board) decide whether it should add a project to develop potential improvements to IAS 32 to its standard-setting programme.

4. In September 2014, we sought ASAF's advice on the scope of the project. ASAF members stated that:

   (a) IAS 32 had proved to be robust during the financial crisis, although new financial products were testing its requirements.

   (b) A fundamental review of the requirements was necessary; however the Board should not necessarily start from an entirely blank sheet of paper. Therefore the Board should seek to provide a better foundation for the requirements of IAS 32 to address issues emerging in practice.

5. In October 2014, the Board decided that this project should investigate potential improvements:

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

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

6. Following ASAF's advice, the Board decided to start with the existing classification requirements of IAS 32 and explore both:

   (a) improvements to those classification requirements to ensure that the underlying principles are robust to deal with existing and new instruments that are posing challenges in practice.

   (b) additional presentation and disclosure requirements within liabilities and within equity. This may provide an additional tool through which some of these problems could also be addressed.

7. In March 2015, the ASAF discussed the feedback that EFRAG received on their Discussion Paper *Classification of Claims*. We sought ASAF's views on the implications of that feedback on the research project. ASAF members suggested that:

(a) the Board should consider the competing objectives of the information resulting from classification (eg including depicting liquidity, solvency, performance and returns to holders of a particular class of instrument) but it should be aware that the financial statements as a whole need to provide information to meet those competing objectives. The distinction between liabilities and equity plays a role in meeting those objectives, but it cannot achieve those objectives in isolation.

(b) claims have many different characteristics and a single distinction cannot communicate all of these different characteristics. The Board will have to consider other ways of presenting information about claims that is relevant to users but that is not conveyed using the selected single distinction.

(c) a liability should be defined positively and equity should continue to be defined as a residual interest.

8. Appendix A includes a more detailed summary of ASAF members' comments.

Discussions since March 2015

9. Since March 2015 the Board has discussed a number of challenges with the existing requirements of IAS 32 and identified three potential approaches for improving the financial reporting requirements to address those challenges.

10. Below is a brief summary of our discussions, including:

(a) What financial reporting challenges were identified? (paragraphs 11–15)

(b) How did the Board plan to approach those challenges? (paragraphs 16–18)

(c) What progress has been made against that plan? (paragraphs 19–32)

What financial reporting challenges were identified?

11. In May 2015 (Agenda Paper 5A), the IASB staff identified a number of perceived financial reporting challenges. We distinguished between the conceptual and application challenges that were identified.

Conceptual challenges

12. Conceptual challenges have to do with identifying the underlying rationale of, and approach to, the distinction between liabilities and equity in IAS 32 and in the Conceptual Framework. Difficulties arise from using a binary distinction to depict a wide range of claims with various features and the polarised financial reporting effects of classifying those claims as either liabilities or equity[1].

13. Conceptual challenges are evident from the various, and sometimes inconsistent, features used to distinguish between liabilities and equity in IAS 32, other IFRSs and the Conceptual Framework. For example, a claim is sometimes classified as equity even though it contains an obligation to transfer economic resources (the 'puttables exception').

14. Financial statements need to provide information about all relevant features in some way. Therefore, the challenge is to identify:

    (a) what information is **best** provided using the distinction between liabilities and equity; and

    (b) what information is **best** provided through disclosure, presentation of subclasses and other means (such as earnings-per-share).

Application challenges

15. Application challenges relate to the consistency, completeness and clarity of the requirements in IAS 32, in particular when those requirements are applied to particular types of transactions in practice, in particular derivatives on 'own equity'. These challenges are evident from the many interpretation requests submitted to the IFRS Interpretations Committee over the past decade, with some of them remaining unresolved.

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[1] For example, claims classified as liabilities are measured 'directly' and included in total liabilities, and changes in these claims meet the definitions if income and expense.

How did the Board plan to approach those challenges?

16. In May 2015 the Board discussed a roadmap for addressing the above challenges. Importantly it noted that the Board needs to:

    (a) identify, confirm (or correct) and reinforce the underlying rationale of the distinction between liabilities and equity in IAS 32;

    (b) identify other relevant features of claims that need to be communicated by means other than the distinction between liabilities and equity; and

    (c) improve the consistency, completeness and clarity of the requirements.

17. To accomplish the above, the Board explored:

    (a) What distinctions between claims might be useful and why?

    (b) How different approaches to the classification might enhance (or diminish) the usefulness of the distinction.

18. The starting point was the features used to distinguish between liabilities and equity in IAS 32.

What progress has been made against that plan?

19. Following that plan the Board:

    (a) Explored the features of claims that are used in IAS 32 to distinguish between liabilities and equity that are relevant to users and why they are relevant. (paragraphs 20–22)

    (b) Identified three approaches (Alpha, Beta and Gamma) based on those features that are candidates for reinforcing the underlying rationale of IAS 32 and improving the requirements (paragraph 22(c)); and

    (c) Discussed additional challenges that arise when accounting for derivatives on 'own equity' (paragraph **Error! Reference source not found.**).

20. In June 2015 (Agenda Paper 5A) the Board discussed:

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

(b) based on the staff analysis, the Board identified the following relevant features:

(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).

21. In July 2015 (Agenda Paper 5A) the Board discussed the various assessments of financial position and financial performance that users might make using information about the identified features. Based on the staff analysis the Board identified the following assessments:

(a) of financial position:

(i) whether the entity is expected to have the economic resources required to meet its obligations **as and when** they fall due. To make that assessment, users need information about claims that require a transfer of economic resources at a specified **time** other than at liquidation.

(ii) whether the entity **has sufficient** economic resources required to meet its obligations at a point in time, if all its claims were to be settled at a point in time. To make that assessment, users need information about claims that require a specified **amount** that is independent of the entity's available economic resources (eg a specified amount of currency units). They will also need information about the **priority** of the claims on liquidation to assess how any potential shortfall, or excess, of economic resources will be distributed amongst claims.

(b) of financial performance:

(i) whether the entity **has produced a sufficient return** on its economic resources to satisfy the promised return on claims against it. To make that assessment, users need information about the promised return on claims for which the specified **amount** changes over time independently of the changes in the entity's available economic resources. They will also need information about the **priority** of the claim on liquidation to assess how any potential shortfall, or excess, of returns will be distributed amongst claims.

22. In September 2015 (Agenda Paper 5A) the Board discussed the existing definitions and other related requirements in IAS 32, and identified:

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

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

(c) three possible approaches (**Alpha, Beta and Gamma**) to improve those requirements that it intends to develop further as the project progresses.

23. The three approaches the Board identified in September 2015 represent different candidates for potential improvements to IAS 32. However, the three approaches address the challenges identified in different ways, and will have different implications regarding:

(a) the classification of liabilities and equity;

(b) which additional sub-classifications, and presentation requirements for those subclasses, are needed to provide information regarding additional features not captured by the distinction between liabilities and equity alone; and

(c) any other changes required to improve the consistency, completeness and clarity of the requirements.

24. Appendix B includes a summary of the three approaches being developed and Appendix C includes a summary of the classification outcomes for some simple instruments.

25. In October 2015 (Agenda Paper 5A) the Board discussed the challenges associated with accounting for derivatives on 'own equity' and how IAS 32 deals with those challenges. In developing approaches to the distinction between liabilities and equity, the Board directed the staff to:

(a) consider how the existing requirements for classifying derivatives on ‘own equity’ in IAS 32 would fit with the underlying rationale of those approaches identified in September 2015; and

(b) identify potential areas in which the existing requirements might be improved.

26. In February 2016, the Board discussed the further development of the three approaches it had identified as potential ways of improving IAS 32. The Board’s discussions focused on developing approach Gamma, because:

(a) it distinguishes claims based on a combination of the features used to distinguish claims in the other approaches.

(b) its classification outcomes are closest to the existing outcomes of IAS 32.

27. The Board discussed:

(a) providing information regarding additional features not captured by the distinction alone using:

(i) further distinctions within liabilities (Agenda Paper 5A) (paragraphs 28–30)

(ii) further distinctions within equity (Agenda Paper 5B) (paragraphs 31–32)

(b) challenges in accounting for claims with conditional alternative liability and equity settlement outcomes (Agenda Paper 5C). This discussion included considering the application of the proposals in the Board’s Exposure Draft *Conceptual Framework for Financial Reporting* (the

CF ED). The Board will continue to consider the challenges with these claims at a future meeting

Further distinctions within liabilities

28. The Board discussed the presentation of income and expense that arises from liabilities with different features. The Board indicated that, under the Gamma approach (as with the Alpha approach), it would be useful to distinguish between:

    (a) income or expense that arises from liabilities for a specified amount, ie an amount that is determined independently from the entity's economic resources (for example, obligations to transfer a fixed amount of currency units, regardless of how they are settled) ; and

    (b) income and expense that arises from liabilities that depend on a residual amount (for example, obligations to transfer an amount of cash equal to the fair value of an entity's ordinary shares).

29. The Board discussed the presentation of liabilities with different features on the face of the statement of financial position. The Board indicated that, under the Gamma Approach (as with the Alpha approach) it would be useful to present separately liabilities that depend on a residual amount.

30. In addition, the Board indicated that it would consider at a future meeting if it would be useful to provide information about the priority of liabilities on the face of the statement of financial position, or in the notes, for all of the approaches being considered.

Further distinctions within equity

31. Although the claims within equity under Gamma will require neither an outflow of resources, nor a fixed return, differences between equity claims will remain. The Board observed that existing IFRS Standards require the attribution of profit or loss and other comprehensive income between non-controlling interests and parent equity interests. The Board indicated that, under all of the approaches being considered, it would be useful to:

(a) require entities to attribute profit or loss and other comprehensive income to some classes of equity other than the ordinary shares of the parent entity.

(b) update the carrying amount of each subclass of equity to reflect any such attribution.

32. The Board observed that some of the claims that would be classified as liabilities under the Gamma approach would be classified as equity under the Alpha (eg share-settled debt) and Beta approaches (eg shares redeemable at fair value). Because of this difference, the Board asked the staff to explore ways to present the attribution of amounts to these classes of equity more prominently than other classes of equity.

Next steps

Board discussions

33. The staff plan to discuss the following topics in future Board meetings:

(a) classification of derivatives on ‘own equity’ in the context of the three approaches .

(b) refinements to the proposed distinction between income and expense that arise from liabilities with different features and how to present income and expense from those two subclasses of liabilities, for example within profit or loss or using the distinction between profit or loss and other comprehensive income.

(c) requirements for determining the amount to be attributed to classes of equity other than ordinary shares.

(d) classification of instruments meeting the existing puttables exception in the context of the three approaches.

(e) conditional alternative settlement outcomes, including the contract boundary and interaction of contracts with legal and regulatory frameworks.

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

(g) additional disclosure requirements, including developing a requirement to provide information about the priority of liabilities and equity on the face of the statement of financial position, or in the notes.

(h) interactions with other IFRSs, IFRICs and the *Conceptual Framework*.

ASAF discussions

34. Given that the ASAF is the primary consultative body for the Conceptual Framework project, we have identified the following topics for discussion at a future ASAF meeting that might be relevant to both the Conceptual Framework project and the FICE project:

(a) The application of the 'present obligation' requirements proposed in the CF ED to claims against the entity with conditional liability and equity alternative settlement outcomes. The CF ED proposed that an entity has a present obligation to transfer economic resources if it has no practical ability to avoid the transfer.

(b) Whether obligations of a specified amount that will be settled using a variable number of shares should be liabilities

Outreach

35. In addition to the technical discussions, we intend to expand our outreach over the coming months. In particular, we would like to focus our efforts on seeking the views of users of financial statements regarding:

(a) the assumptions we have made regarding the relevance of information about particular features to different assessments that users might make.

(b) the usefulness of different ways of arranging that information in the financial statements to facilitate those assessments.

36. We will be preparing materials for outreach with users and we would be happy to share these with ASAF members to use in their outreach. A discussion of the feedback from users could also be the subject of a future ASAF meeting.

Questions for ASAF members
1) Do ASAF members agree with the suggested topics for future discussions? 2) Do ASAF members have any other questions or comments?

Appendix A—Summary of past ASAF discussions

September 2014

37. At the September 2014 ASAF meeting the IASB staff presented the ASAF with a paper outlining two broad alternatives that the Board could consider in proceeding with the project:

    (a) a fundamental review of IAS 32; or

    (b) maintenance of IAS 32, but with improvements to its presentation and disclosure requirements.

38. Many ASAF members stated that while a fundamental review of the requirements was necessary, the Board should not necessarily start from an entirely blank sheet of paper. IAS 32 had proved to be robust during the financial crisis, although new financial products, such as bonds that are contingently convertible into equity if a non-viability event occurs, were testing the requirements. A fundamental review is needed to provide a better foundation and should focus on identifying the objectives of the distinction between liabilities and equity.

39. Some ASAF members cautioned the Board against pursuing a narrow-scope project, because of the risk of introducing further exceptions and inconsistencies.

40. Some ASAF members stated that it is important that the Board should consider the distinction between liabilities and equity from the perspectives of both financial position and financial performance.

41. One ASAF member asked for more clarity about the plan to revisit the Conceptual Framework definitions after performing the research. Another ASAF member stated that the decision to consider the distinction between liabilities and equity further in the research project was not consistent with the decision to expose the tentative definitions in the Exposure Draft. Yet another ASAF member thought that the Conceptual Framework project should take the lead and not follow the research project.

March 2015

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

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

43. 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 given that 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 in 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 Board 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.

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

45. ASAF and Board members commended the EFRAG for its work with many noting that it was very informative and useful.

46. 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 Board 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 Board member suggested an enhanced statement of changes in equity as a possible solution. ASAF members acknowledged that the Board will have to consider other ways of presenting information about claims that is 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 will 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.

Appendix B—Summary of approaches being developed

Approach	Alpha	Beta	Gamma
Distinction between liabilities and equity under each approach Discussed in September 2015 (Agenda Paper 5A)	Distinguish between: (a) liabilities–obligations to transfer economic resources at particular points in time other than at liquidation; and (b) equity–obligations to transfer economic resources only at liquidation.	Distinguish between: (a) liabilities–obligations for a specified amount independent of the economic resources; and (b) equity–obligations for a residual amount.	Distinguish between (a) liabilities–obligations (i) to transfer economic resources at particular points in time other than at liquidation <u>or</u> (ii) for a specified amount independent of the economic resources; and (b) equity–obligations (i) to transfer economic resources only at liquidation <u>and</u> (ii) for a residual amount.

Approach	**Alpha**	**Beta**	**Gamma**
Which assessment is the approach to the distinction between liabilities and equity focused on? Assessments discussed in July 2015 (Agenda Paper 5A)	To what extent will the entity have the economic resources required to meet its obligations **as and when** they fall due?	To what extent will the entity have: • sufficient economic resources to satisfy the total claims against it? • produced a sufficient return on its economic resources to satisfy the promised return on claims against it? How will any potential shortfall or excess in economic resources or returns be distributed amongst claims?	Both sets of assessments facilitated by Alpha and Beta, however, further distinctions within liabilities are required to properly make those assessments.

Approach	Alpha	Beta	Gamma
Which features are relevant to those assessments? Assessments discussed in July 2015 (Agenda Paper 5A) Features discussed in June 2015 (Agenda Paper 5A)	To make that assessment, users need information about claims that require a transfer of economic resources at a specified **time** other than at liquidation.	To make that assessment, users need information about claims that require a specified **amount** that is independent of the entity's available economic resources (eg a specified amount of currency units). They will also need information about the **priority** of the claims on liquidation.	Both sets of features used in Alpha and Beta.

Approach	**Alpha**	**Beta**	**Gamma**
What kinds of ratios would it help facilitate?	Liquidity (eg current ratio and quick ratio) ‘Flighty’ vs long-term funding	Solvency/loss absorbing capacity (eg debt/capital ratio) Financial leverage ratio analysis Interest coverage, return leverage analysis (eg EBIT/interest expense, debt/EBIT, return on equity)	Both sets of questions, however, liabilities will have to be further disaggregated as the totals will include a mix of features.
What kinds of questions would it help users answer?	Does this company manage its cash effectively? Will this company have enough cash to pay suppliers and debtholders, as they fall due?	Can this company access additional finance, borrow more money from subordinated claims? Is it constrained by debt-overhang? Can this company generate returns in excess of the returns it is obliged to deliver (ie debt service)? Which claims participate in upside?	Both sets of questions, however, liabilities will have to be further disaggregated as the totals will include a mix of features.

Appendix C—Summary of classification outcomes under the proposed approaches (shaded text indicates outcome of preliminary view being discussed in this meeting)

Claim	Alpha	Beta	Gamma	IAS 32	CF ED
Ordinary bonds	Liability with income or expense presented in profit or loss (if measured at fair value, income or expense related to changes in credit risk presented in other comprehensive income (consistent with IFRS 9)).				Liability with income or expense presented in the statement(s) of financial performance
Ordinary shares	Equity with changes calculated as total comprehensive income less any amounts attributed to senior equity claims presented.				Equity
Shares redeemable for their fair value (assume does not meet the puttables exception in IAS 32)	Liability with income or expense presented separately	Equity with changes presented as an attribution of total comprehensive income before ordinary shares	Liability with income or expense presented separately	Liability with changes reported in profit or loss	Liability with income or expense presented in the statement(s) of financial performance

Claim	Alpha	Beta	Gamma	IAS 32	CF ED
Shares redeemable for their fair value (assume does meet the puttable exception)	To be discussed at a future meeting			Equity, carrying amount is not directly updated for subsequent changes, (but additional disclosure in IAS 1)	Liability with income or expense presented in the statement(s) of financial performance
Obligation to deliver a fixed number of shares (assume entity has the ability to issue additional shares without repurchasing shares)	Equity, to discuss in a future meeting whether any further requirements are needed other than disclosure through IAS 33 *Earnings per Share*.			Equity, carrying amount is not directly updated for subsequent changes (but additional disclosure requirements in IAS 33)	Equity

Claim	Alpha	Beta	Gamma	IAS 32	CF ED
Share-settled bonds (obligations to deliver a variable number of ordinary shares equal to an amount independent of the entity's economic resources)	Equity with changes presented as an attribution of total comprehensive income before ordinary shares	Liability with changes presented consistently with ordinary bonds	Liability with changes presented consistently with ordinary bonds	Liability with changes reported in profit or loss	Equity
Cumulative preference shares	Equity with changes presented as an attribution of total comprehensive income before ordinary shares	Liability with changes presented consistently with ordinary bonds	Liability with changes presented consistently with ordinary bonds	Equity, with additional disclosure requirements in IAS 33	Equity

Claim	Alpha	Beta	Gamma	IAS 32	CF ED
Non-cumulative preference shares	Equity with changes presented as an attribution of total comprehensive income before ordinary shares			Equity, with additional disclosure requirements in IAS 33	Equity