STAFF PAPER

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IASB Meeting

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

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Introduction

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

2. In February 2016 the Board discussed:

   (a) whether changes in some liabilities should be distinguished in some way either in profit or loss or in other comprehensive income, and whether balances should be distinguished in the statement of financial position (the separate presentation requirements). We did not offer a definition for the subclass, but we suggested that one instrument for which the different presentation requirements will be useful for would be an ordinary share[1] redeemable by the holder at fair value.

   (b) whether profit or loss and other comprehensive income should be attributed to classes of equity claims other than ordinary shares.

3. In this meeting we expand February's analysis of the separate presentation requirements for financial liabilities to consider:

[1] an ordinary share being an obligation that requires the entity to transfer economic resources only at liquidation for an amount equal to the fair value of a claim to a pro-rata share of the entity's net assets on liquidation

(a) whether standalone derivatives that depend on the residual amount should be subject to the proposed separate presentation requirements; and

(b) how the separate presentation requirements might apply to a hybrid financial liability[2] which contains an embedded derivative that depends on the residual amount.

4. We will also consider different approaches for determining the amount of profit or loss and other comprehensive income to be attributed to derivatives and non-derivatives classified as equity.

5. In this meeting, we have not considered refinements to the fixed-for-fixed condition, or changes to the classification and separation of components of compound financial instruments.[3]

6. We intend to consider whether any changes are required to address the classification of foreign currency convertible bonds and other challenges with the fixed-for-fixed condition at a future meeting. We think that deferring that discussion until after we consider the application of the separate presentation requirements to derivatives will aid the Board when considering the classification challenges concerning more complex compound instruments.

7. As before, we will be focusing on the Gamma Approach.

8. The papers that we are discussing at this meeting include:

(a) Agenda Paper 5A—Scope of separate presentation requirements for liabilities that depend on the residual amount.

(b) Agenda Paper 5B—Attribution of profit or loss and other comprehensive income to classes of equity claims other than ordinary shares.

(c) Agenda Paper 5C—Agenda Consultation feedback. This paper is for information only.

[2] Hybrid financial liabilities in IFRS 9 *Financial Instruments* are those liabilities that include an embedded derivative.

[3] Compound instruments in IAS 32 *Financial Instruments: Presentation* are those financial instruments that include both liability and equity components.

9. The rest of this cover note includes:

   (a) Where are we? (paragraphs 10–37)

   (b) What will we be discussing at future meetings? (paragraph 38)

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

   (d) Appendix B—Summary table of the classification consequences for instruments already discussed

Where are we?

10. The objective of this project is to investigate perceived financial reporting challenges with IAS 32 and to assess potential ways to improve financial reporting or to remedy an identified deficiency in IAS 32. This analysis will help the Board decide whether it should add a project to develop potential improvements to IAS 32 to its standard-setting programme.

11. 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.

12. In 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.

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

    (a) What financial reporting challenges were identified? (paragraphs 14–18)

(b) How does the Board plan to approach those challenges? (paragraphs 20–22)

(c) What progress has been made against that plan? (paragraphs 23–37)

What financial reporting challenges were identified?

14. 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

15. 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[4].

16. 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').

17. 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

18. Application challenges relate to the consistency, completeness and clarity of the requirements in IAS 32, in particular when those requirements are applied to

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

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.

19. Interpretation requests remaining unresolved include:

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

(b) Some types of contingent convertible bonds, including a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event.

How does the Board plan to approach those challenges?

20. 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.

21. 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.

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

What progress has been made against that plan?

23. 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 24–26)

(b) Identified three approaches (Alpha, Beta and Gamma) based on the features we identified that are candidates for reinforcing the underlying rationale of IAS 32 and improving the requirements (paragraph 27-29); and

(c) Discussed additional challenges that arise when accounting for derivatives on 'own equity' (paragraph 30).

(d) Discussed the presentation of different subclasses of liabilities and of equity (paragraph 31–37).

24. 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).

25. 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 (eg the reporting date), 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.** The specified amount of a claim may exceed the entity's economic resources if it is specified 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. A promised return may exceed the return on the entity's economic resources if the specified **amount** of the claim 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.

26. 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.

27. In September 2015 the Board identified three possible approaches (**Alpha, Beta and Gamma**) to improve those requirements that it intends to develop further as the project progresses.

28. Those three approaches 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 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.

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

30. 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.

31. 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.

32. In addition, in February 2016 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 33–35)

(ii) further distinctions within equity (Agenda Paper 5B) (paragraphs 36–37)

(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

33. 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).

34. 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.

35. 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

36. 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.

37. 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.

What topics are we discussing at future meetings?

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

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

(b) conditional alternative settlement outcomes, including the contract boundary and interaction of contracts with legal and regulatory frameworks. As part of this topic, the staff intends to consider the application of the proposals in the Exposure Draft *Conceptual Framework for Financial Reporting* which will benefit both the Conceptual Framework project and this project.

(c) recognition, derecognition and reclassification of equity instruments (and components), including on settlement, conversion, expiration modification and other events. This will follow on from the discussion of attribution of profit or loss and other comprehensive income to classes of equity instruments other than ordinary shares.

(d) 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.

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

Appendix A—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 or (ii) for a specified amount independent of the economic resources; and (b) equity–obligations (i) to transfer economic resources only at liquidation and (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 B—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 classes of equity claims other than ordinary shares.				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