

STAFF PAPER

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Project	Financial Instruments with Characteristics of Equity research project		
Paper topic	Agenda Consultation feedback		
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Introduction

1. The purpose of this paper is to provide input for the Board to consider when it analyses feedback received on particular projects in the Agenda Consultation. We have also included, where appropriate, feedback from the accompanying online survey. No questions will be asked.
2. More than half of the respondents to the Agenda Consultation explicitly referred to the Financial Instruments with Characteristics of Equity research project (the research project), representing a broad mix of types of respondent and geographical regions. Those that *did not* explicitly mention the project included some preparers and most of the users that responded. However, we note below that, while users did not explicitly mention the project, many of the topics they did mention relate to topics that the research project is investigating.
3. For an overview of the status of the project, please refer to Agenda Paper 5.
4. This paper is structured as follows:
 - (a) Comments on the objective and scope of our existing research project
 - (b) Who thinks this project is important and why?
 - (c) Who thinks this project is unimportant and why?
 - (d) Who thinks this project is urgent and why?

Comments on the objective and scope of our existing research project

5. Some of the respondents to the Agenda Consultation that referred to the project discussed the scope of the project. There were broadly two different views on the scope of the project:
 - (a) Some standard setters and accounting firms suggested that a fundamental review of the concepts (or requirements) underpinning IAS 32 *Financial Instruments: Presentation* is necessary as an extension of the Conceptual Framework project. Some respondents noted that a fundamental review of the concepts is necessary given the lack of discussion regarding the distinction between liabilities and equity in the recent Exposure Draft *Conceptual Framework for Financial Reporting*.
 - (b) A few financial institution representative bodies suggested a more narrow focus in order to address the particular application difficulties encountered in applying IAS 32.
6. As we noted in Agenda Paper 5, we have identified both conceptual and application challenges that need to be addressed by the research project. In particular we noted that some interpretations requests submitted to the Interpretations Committee remain unresolved. The Board concluded that identifying and reinforcing the underlying rationale of IAS 32 would be necessary to address some of the application challenges identified.
7. A few respondents mentioned particular topics that they think the Board should consider as part of the project. These included:
 - (a) The interaction with IFRS 2 *Share-based Payments*.
 - (b) Islamic finance products such as perpetual sukuk and unrestricted investment accounts.
 - (c) The measurement of options on non-controlling interests.
8. In the staff's view, the above topics could be considered in the context of the approach identified in paragraph 6. With respect to IFRS 2, we note that investigating challenges with IFRS 2 is not in the scope of the project, however

the Board will have to consider any implications arising from any potential changes to the *Conceptual Framework*.

9. Although users did not mention the project explicitly, and therefore did not address the scope of the project explicitly, a few of their responses to the Agenda Consultation (and accompanying online survey) mentioned topics that the staff thinks would fall within the scope.

10. One European user representative group mentions the need for better information about dilution and participation, along with improved disclosure regarding the liquidity demands on the entity. This group suggests that:

“investors are in need of a more complete overview of all (potential) sources of dilution per year end, and what the main characteristics are of these sources. The scope should include instruments that, like common equity, share without limit in the upside potential of the enterprise.”¹

11. Another international user representative group mentioned the need for greater information about priority, fair values, sensitivities and value transfers between claim holders. This user group suggested that any project in this area should pursue improved disclosure and understanding for investors over a perfect distinction for balance sheet classification. They also suggested that:

“a re-measurement disclosure which fair values liability, equity and liability/equity and shows the transfer of value between the capital providers to the entity would be highly decision-useful to investors and very instructive to those who see the fair valuing of debt as counterintuitive.”²

12. In the staff’s view, the overall approach we are taking in the research project to address the identified challenges is consistent with the suggestions of users of financial statements.

¹ CL48

² CL119

Who thinks this project is important and why?

13. Out of those that specifically ranked the importance of the research project most rated the project either high (many) or medium (some). This included most of the standard-setters and similar bodies, accounting bodies and firms, and regulators and half of the preparers that rated the importance of the project. We did not identify any geographic trends.
14. Reasons for the importance of the project included:
 - (a) The need to follow on the work in the *Conceptual Framework*.
 - (b) The need to address identified issues with IAS 32 regarding existing diversity in practice and new forms of financing.
15. No users responded to the ranking question directly. However, as noted in paragraphs 9-11, some users did mention related issues, and ranked them as of high or medium importance.
16. Some users that responded to the accompanying online survey suggested that the project is needed to:
 - (a) Address the accounting for new hybrids.
 - (b) Address the abuse by preparers that mislead investors by not representing the substance of financing transactions.
 - (c) Improve a key distinction that influences financial statement ratios and performance.
 - (d) Improve information about participation, because of the lack of disclosure at the moment about the effect of other claims on the most residual claim.

Who thinks this project is unimportant and why?

17. A few respondents specifically ranked the importance of the FICE project as low. Most of these few respondents were preparers.
18. Reasons for the unimportance of the project included:

- (a) They are unaffected by the problems, or do not know who would be affected by the problems.
 - (b) They do not think it is feasible to reach a solution.
19. Some respondents to the Agenda Consultation did not mention anything about the project. Most of these respondents included roughly half of the preparers and some of the users.

Who thinks this project is urgent and why?

20. Most of the respondents that specifically ranked the urgency of the project, ranked it broadly consistently with how they ranked its importance.
21. Some of those respondents noted that the distinction between liabilities and equity was not addressed as part of the Conceptual framework project.
22. A few financial institution representative bodies suggested that some of the application issues not addressed by the Interpretations Committee are more urgent than the Conceptual issues. Therefore, they suggested a more narrow focus in order to address the particular difficulties encountered in applying IAS 32.
23. A few respondents ranked its urgency less than its importance. These respondents did not provide a reason for the difference; however it might reflect the difficulty of the project, and the prior attempts at addressing the challenges.

Other information

24. The FASB will soon undertake its own consultation on its agenda. One of the projects that it has identified as a potential priority is a project on liabilities and equity.