STAFF PAPER

February 2015

IASB Meeting

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

CONTACT(S)	Manuel Kapsis	mkapsis@ifrs.org	+44272466459

Introduction

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

2. This cover note includes:

    (a) Where are we? (paragraphs 3–18)

    (b) What are the next steps? (paragraphs 19–23)

    (c) What are we discussing at this meeting? (paragraphs 24–25)

    (d) What will we be discussing at future meetings? (paragraph 26)

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

    (f) Appendix B—Summary table of the classification consequences for instruments already discussed (including consequences of staff preliminary views at this meeting)

Where are we?

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 or to remedy an identified deficiency. This analysis will help the IASB

decide whether it should add a project to develop potential improvements to IAS 32 to its standard-setting programme. We are investigating 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.

4. In 2015 we discussed a number of challenges with the existing requirements of IAS 32 and set out three potential approaches for improving the financial reporting requirements to address those challenges.

5. The below is a brief summary of our discussions in 2015, including:

(a) What financial reporting challenges did we identify?

(b) How did we plan to approach those challenges?

(c) What progress did we make against that plan?

What financial reporting challenges did we identify?

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

Conceptual challenges

7. 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.

8. 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.

9. Information about all relevant features will need to be provided in the financial statements 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

10. Application challenges have to do with 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.

How did we plan to approach those challenges?

11. In May 2015 we also set out a roadmap for addressing the above challenges. Importantly we noted that we need 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.

12. To accomplish the above, we 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.

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

What progress did we make against that plan?

14. Following that plan we:

(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 15–16)

(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 17); and

(c) Discussed additional challenges that arise when accounting for derivatives on 'own equity' (paragraph 18).

15. In June 2015 (Agenda Paper 5A) and July 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 potentially affects the amount, timing and uncertainty of (the prospects for) future cash flows**.

(b) 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).

(c) the various assessments of financial position and financial performance that users might make using information about the identified features. Based on our analysis we concluded that:

(i) Information about the **timing** of a required transfer of economic resources will help users to assess whether the entity is expected to have the economic resources required to meet its obligations **as and when** they fall due.

If the **timing of that required transfer is other than at liquidation (**eg specified dates), then users will need to know the **amount** and **type** of economic resources required to be transferred to make that assessment.

(ii) Information about how the **amount** of economic resources required to settle the claim is determined will help users to assess the extent to which 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.

If that **amount** is specified **independently** of the amount of the entity's economic resources (eg a specified amount of currency units, fixed interest return), then users will need to know the **priority** of the claim on liquidation to assess how any potential shortfall will be distributed amongst claims.

(iii) Information about how the **amount** of economic resources required to settle the claim changes over time (ie the promised return),will help users to assess the extent to which the entity **has produced a sufficient return** on its economic resources to satisfy the promised return on claims against it.

If that **amount changes independently** of the changes in the entity's actual economic resources, then the **priority** of the claim on liquidation will also be relevant to assess how any potential shortfall in returns will be distributed amongst claims.

16. In September 2015 (Agenda Paper 5A) we analysed 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.

17. In September 2015 we also outlined three possible approaches (Alpha, Beta and Gamma) for improvements that we intend to develop further as the project progresses. Those approaches were based on our analysis of the features of claims and why information about those features might be relevant to users of financial statements. **Appendix A includes a summary of those approaches.**

18. In October (Agenda Paper 5A) we analysed 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 IASB 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.

What are the next steps?

19. The three approaches we identified 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.

20. We envisage asking the IASB to form a preliminary view at some point this year as to its preferred approach.

21. Before the IASB forms a preliminary view, we plan:

    (a) to explore developing subclasses within liabilities and within equity to provide information regarding additional features not captured by the distinction alone; and

    (b) to further develop the proposed approaches with regards to derivatives on 'own equity' and address some remaining topics.

22. In order to speed the process up we intend to focus on developing the Gamma approach and set out how the Alpha and Beta approaches might differ by comparison, as opposed to developing each approach separately.

23. We are focussing on Gamma because it contains features used in both Alpha and Beta, and because its classification outcomes are closest to the existing outcomes of IAS 32 (as illustrated in September 2015).

What topics are we discussing at this meeting?

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

    (a) **Agenda Paper 5A: Presentation: Subclasses of liabilities including presenting income and expense arising from particular types of liabilities.** Includes the presentation of subclasses of financial liabilities needed for enhancing the reporting of an entity's financial performance and financial position.

    (b) **Agenda Paper 5B: Presentation: Attribution of profit or loss and other comprehensive to sub-classes of equity.** Includes subclasses and subtotals needed for reporting the allocation of residual returns amongst equity claims to provide information to help a user assess the entity's financial position and financial performance.

    (c) **Agenda Paper 5C: Claims with conditional alternative settlement outcomes**. In this paper we discuss claims with alternative liability or equity settlement outcomes (alternative settlement outcomes) that are:

        (i) conditional on rights within the control of the entity; or

(ii) contingent on the occurrence or non-occurrence of uncertain future events beyond the control of both the entity and holder of the claim.

25. The focus of this meeting is on developing the Gamma Approach further including:

(a) developing the additional tools needed to provide information other than through the distinction between liabilities and equity. This includes considering how the carrying amounts, and changes in the carrying amounts, of claims should be presented to help a user assess the entity's financial position and financial performance.

(b) considering claims with conditional alternative settlement outcomes. As part of this discussion we consider:

(i) to what extent the Gamma approach, by the nature of the features it focuses on, reduces the set of claims that are affected by the challenges we identify; and

(ii) whether we should amend some of the existing requirements in IAS 32 to reflect the IASB's current thinking as reflected in the recent Exposure Draft *Conceptual Framework for Financial Reporting*.

What topics are we discussing at future meetings?

26. Remaining topics to be addressed include:

(a) Discussing the existing puttables exception in the context of the three approaches.

(b) Developing potential changes to the requirements for derivatives on own equity required to implement each approach.

(c) Contract boundary and interaction of contracts with legal and regulatory frameworks.

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

(e) Discuss additional disclosure requirements.

(f) Discuss interactions with other IFRSs, IFRICs and 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)	Distinguishes between: (a) liabilities–claims with obligations to transfer economic resources at particular points in time other than at liquidation; and (b) equity–claims with obligations to transfer economic resources only at liquidation.	Distinguish between: (a) liabilities–claims with obligations for a specified amount independent of the economic resources; and (b) equity–claims with obligations for an amount that depends on the residual economic resources.	Distinguish between (a) liabilities–claims with 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–claims with obligations (i) to transfer economic resources only at liquidation and (ii) for an amount that depends on the residual economic resources.

Approach	Alpha	Beta	Gamma
Which assessment is the approach to the distinction between liabilities and equity focused on facilitating? Assessments discussed in July 2015 (Agenda Paper 5A)	The extent to which the entity is expected to have the economic resources required to meet its obligations **as and when** they fall due	The extent to which the entity has: • sufficient economic resources to satisfy the total claims against it **if they were to be settled at a point in time**, and how any potential shortfall will be distributed amongst claims • produced a sufficient return on its economic resources to satisfy the promised return on claims against it, and how any potential shortfall in returns will be distributed amongst claims	Both sets of assessments facilitated by Alpha and Beta, however further disaggregation is required to properly make 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)	For this assessment, users need information about the required **timing** of the transfer of economic resources to settle the claim. If that **timing** is **other than at liquidation (**eg specified dates), then the **amount** and **type** of economic resources that the claim requires the entity to transfer will also be relevant. However, how that amount is specified/determined is not relevant.	For these assessment, users need information about how the **amount** of economic resources required to settle the claim at that point in time is determined, and how that amount changes over time (the promised return) regardless of when the transfer of economic resources is required. If that **amount** is **independent** of the availability of the entity's actual economic resources (eg a specified amount of currency units, fixed interest return), then the **priority** of the claim on liquidation will also be relevant.	Both sets of features

Approach	Alpha	Beta	Gamma
What kinds of ratio's 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 wisely? Will this company have enough cash to pay suppliers and debtholders?	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 profit or loss or other comprehensive income
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 in other comprehensive income	Equity with changes presented as an attribution of total comprehensive income before ordinary shares	Liability with income or expense presented in other comprehensive income	Liability with changes reported in profit or loss	Liability with income or expense presented in profit or loss or other comprehensive income

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, with additional disclosure in IAS 1	Liability with income or expense presented in profit or loss or other comprehensive income
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 earnings-per-share.			Equity, with 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 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 pref 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 pref shares	Equity with changes presented as an attribution of total comprehensive income before ordinary shares			Equity, with additional disclosure requirements in IAS 33	Equity