STAFF PAPER

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IASB® meeting

Project	Financial Instruments with Characteristics of Equity	
Paper topic	Project proposal — moving the project to the standard-setting programme	
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Purpose of this paper

1. The purpose of this paper is to ask the Board whether it agrees with the staff recommendation to move the *Financial Instruments with Characteristics of Equity* (FICE) project from the research programme to the standard-setting programme. It is not possible to publish an Exposure Draft for a project that is on the research programme.

2. In considering whether to add a standard-setting project to the work plan, the Board requires the development of a specific project proposal and an assessment against the project criteria outlined in paragraph 5.4 of the IFRS Foundation‘s *Due Process Handbook*.

3. At the September 2019 Board meeting, the Board discussed the direction of the FICE project. The Board tentatively decided on an approach that addresses practice issues by clarifying some principles in IAS 32 *Financial Instruments: Presentation* (IAS 32). At the October 2019 Board meeting, the Board discussed the project plan for the FICE project. In particular, the Board discussed the practice issues that it could address in the scope of the project and an indicative project timeline outlining the expected commencement of Board deliberations on each issue.

4. The following sections:

   (a) give a brief background on the FICE project (paragraphs 7-14 of this paper);

(b) describe the criteria in the Due Process Handbook that have to be met before a project is added to the standard-setting programme (paragraphs 15-16 of this paper); and

(c) explain why the staff are of the view that those criteria have been met (paragraphs 17-35 of this paper).

5. If the Board decides to add a standard-setting project to its agenda, it also needs to decide whether to set up a consultative group for the project. This is discussed is paragraphs 36-37 of this paper.

Summary of staff recommendation[s]

6. The staff recommend that the Board:

(a) moves the FICE project to its standard-setting programme; and

(b) continues using the expertise of existing advisory bodies instead of establishing a dedicated consultative group for the project.

Background on the FICE project

7. The overall objective of the FICE project is to improve the information that companies provide in their financial statements about financial instruments they have issued, by:

(a) investigating application challenges with the classification of financial instruments applying IAS 32; and

(b) considering how to address those challenges through clearer principles for classification and enhanced requirements for presentation and disclosure.

8. The Board considered some aspects of distinguishing liabilities from equity as part of its project to revise the *Conceptual Framework for Financial Reporting* (Conceptual Framework). As part of that project the Board decided that the Conceptual Framework should continue to make a binary distinction between liabilities and equity. However, in 2014 the Board decided to further explore how to distinguish liabilities from equity as part of a separate FICE project because it did not want to delay other much-needed improvements to the Conceptual Framework. Consequently, the revised Conceptual

Framework issued in 2018 does not address classification of financial instruments with characteristics of equity.

9. In June 2018, the Board published the Discussion Paper on FICE (2018 DP). Taking into account the feedback received on the 2018 DP, the Board tentatively decided in September 2019 not to pursue the classification approach proposed in the DP. Instead, the Board tentatively decided to explore making clarifying amendments to IAS 32 to address common accounting challenges that arise in practice when applying IAS 32. The Board will aim to do this by clarifying underlying principles in IAS 32 or improving the clarity of the articulation of those principles, if necessary. Where there is not an implicit or explicit principle in IAS 32 for a particular requirement in IAS 32, the Board could fill this gap by developing a principle and accompanying rationale.

10. The Board is seeking to limit changes to classification outcomes to those in which sufficient evidence exists that such a change would provide more useful information to users of financial statements. In addition, the Board intends to further develop some of the presentation and disclosure proposals explored in the 2018 DP.

11. At the September 2019 Board meeting, to help ensure that the project proceeds in an efficient manner, the Board also considered a set of criteria to identify the issues that should be within the project scope. In October 2019 the Board identified a number of practice issues that are likely to meet such criteria.

12. In December 2019 and April 2020, the Board discussed one of the main sources of accounting challenges in practice and arguably one of the most difficult challenges to solve, namely classifying financial instruments settled in an entity’s own equity instruments (particularly applying the fixed-for-fixed condition to derivatives). The Board tentatively decided on potential clarifications to the underlying principle for classifying derivatives on own equity using a foundation principle and an adjustment principle.

13. During 2020 the staff have also been performing research and undertaking outreach on the following topics:

    (a) potential refinements to the 2018 DP disclosure proposals (*outreach with investors and other stakeholders*); and

(b) classification of particular financial instruments containing obligations that arise only on liquidation of the entity eg perpetual instruments (*targeted outreach with equity investors*).

14. Taking into account the work performed while the FICE project has been on the research programme and the stakeholder support for the project, the staff believe the Board now has sufficient information to make a decision on whether to add a project to its standard-setting programme.

Criteria for adding a project to the standard-setting programme

15. The Due Process Handbook states that when adding a standard-setting project to its agenda or making major amendments to existing Standards, the Board evaluates the merits of adding the project primarily on the basis of the needs of users of financial reports, while also taking into account the costs of preparing the information. When deciding whether a proposed agenda item will address the needs of users of financial statements, the Board considers:

(a) whether there is a deficiency in the way particular types of transactions or activities are reported in financial reports;

(b) the importance of the matter to those who use financial reports;

(c) the types of entities likely to be affected by any proposals, including whether the matter is more prevalent in some jurisdictions than others; and

(d) how pervasive or acute a particular financial reporting issue is likely to be for entities.[1]

16. The Due Process Handbook also states the Board should only add a standard-setting project if it concludes that the benefits of the improvements to financial reporting will outweigh the costs.[2]

[1] *Due Process Handbook*, paragraph 5.4.
[2] *Due Process Handbook*, paragraph 5.7.

Staff analysis of the FICE project

17. The following sections describe the work the Board and staff have undertaken to assess:

    (a) whether there is a deficiency in current reporting (paragraphs 18-23 of this paper);

    (b) the importance of any deficiency to users of financial statements (paragraphs 24-27 of this paper);

    (c) the types of entities likely to be affected by the proposals and the pervasiveness of the problem (paragraphs 28-32); and

    (d) the costs and benefits of the proposals (paragraphs 33-35).

Deficiencies in current reporting

18. Entities have been applying IAS 32 to most financial instruments without any significant problems. Furthermore, the Board is not aware of any evidence to suggest that there were fundamental problems with IAS 32 during the global financial crisis of 2007–2008. However, due to market forces, financial innovation and changes in bank capital regulations, there has been a growing set of financial instruments with characteristics of equity that have presented challenges when entities apply IAS 32.

19. The 2018 DP highlighted a number of conceptual and application challenges in distinguishing liabilities from equity. For some financial instruments, the application of IAS 32 is clear; however, some stakeholders disagree with the classification outcome, or with some of the financial reporting consequences of that outcome. However, for some other financial instruments, it is unclear how entities should apply the requirements of IAS 32 to classify them as financial liabilities or equity instruments and that results in diversity in practice.

20. The Board has also become aware of challenges in applying IAS 32 when distinguishing financial liabilities from equity instruments from submissions to the IFRS Interpretations Committee (Interpretations Committee). The Interpretations Committee was unable to reach a consensus on some of these submissions because the Interpretations Committee

found it difficult to identify a clear and consistent classification principle in IAS 32. These submissions highlighted the existence of inconsistencies and complexity in application as well as some disagreement about particular classification outcomes when applying IAS 32.

21. In addition, various deficiencies in IAS 32 were highlighted through the 128 comment letters received on the 2018 DP and various stakeholders have also sent further examples of practice issues directly to the staff.

22. In October 2019 the staff identified specific practice issues that the Board could address in the scope of the project. The preliminary list of such issues is as follows:

    (a) classification of financial instruments that will or may be settled in the issuer's own equity instruments, eg application of the fixed-for-fixed condition to particular derivatives on own equity and the classification of mandatorily convertible financial instruments;

    (b) accounting for obligations to redeem own equity instruments, eg accounting for written put options on non-controlling interests (NCI puts);

    (c) accounting for financial instruments that contain contingent settlement provisions, eg financial instruments with a non-viability clause;

    (d) the effect of laws and regulations on the classification of financial instruments;

    (e) reclassification between financial liability and equity instruments, eg when circumstances change, or contractual terms are modified; and

    (f) classification of particular financial instruments containing obligations that arise only on liquidation of the entity, eg perpetual financial instruments.

23. In the staff's view, the Board therefore has sufficient information from the feedback received on the DP and previous consultations and from Interpretations Committee discussions and stakeholder examples to conclude that there are deficiencies in current reporting.

Importance to users of financial statements

24. The classification of financial instruments as financial liabilities or equity, and the further disaggregation within financial liabilities and within equity, can affect calculations of the entity's cost of capital and the expected return on investments for users of financial statements. The absence of information about different financial instruments classified as equity may be the reason why many equity investors support a very narrow definition of equity which only includes issued ordinary shares.

25. Users of financial statements are also affected by diversity in practice in applying the classification requirements of IAS 32 which reduces the comparability and understandability of financial statements. Comparability is also difficult to achieve with financial instruments given that similar outcomes can be achieved with various combinations of features and different outcomes can be achieved with similar features. Such diversity makes it difficult for users of financial statements to assess how these financial instruments affect the issuers' financial position and performance. In addition, investors have been calling for more information to be disclosed about equity instruments.

26. The detailed feedback received on the 2018 DP from users of financial statements was summarised at the July 2019 Board meeting. Some users of financial statements mentioned that they are challenged by distinguishing liabilities from equity and acknowledged that analysts often make their own classifications by making adjustments to the entity's classification. Most users of financial statements supported the additional disclosures proposed in the 2018 DP and said it would bring more transparency and help them understand the financial instruments so that they can perform their own analyses and valuations. However, users of financial statements also highlighted a number of challenges with and suggestions for the proposed disclosures.

27. In response to these and other challenges and suggestions, the staff developed potential refinements for each type of disclosure proposed in the 2018 DP. During 2020, the staff performed additional outreach with users of financial statements on these potential disclosure refinements. Users of financial statements generally supported the potential

disclosure refinements, acknowledging that they improve the disclosures proposed in the 2018 DP and take into account feedback from stakeholders.

Types of entities affected and the pervasiveness of the problem

28. Given the nature of the practice issues identified in paragraph 22 of this paper, the wide variety of issued financial instruments, continuing financial innovation and the fundamental nature of a binary classification, many different types of entities might be affected. For example, the introduction of new regulatory requirements after the financial crisis has increased the variety and amount of ‘bail-in’ instruments issued by financial institutions. Non-financial corporates issue ‘hybrid’ securities for a variety of reasons including capital management, tax and, more recently, investor demands for higher yields. These ‘hybrid’ securities were primarily issued by companies in the utilities sector but in recent years companies from wider industries have issued such instruments, including telecommunication, oil and gas, and automobile industries.

29. Capital structures have evolved over time in different ways in different jurisdictions. For example, in many jurisdictions, mandatory tender offers on acquisition of a controlling interest are common regulatory requirements. In other jurisdictions it is quite common (although not legally required) for significant non-controlling interest shareholders to hold put options on their shares. These may not be as pervasive as when the requirements are legally required, but the effect can be acute for many entities.

30. Feedback on the 2018 DP highlighted that accounting diversity in practice is more significant and widespread than the Board expected. In particular, the interpretation of the IAS 32 fixed-for-fixed condition in practice seems to be broader than anticipated. In addition, in many developing economies, foreign currency convertible bonds are frequently issued to access more developed foreign capital markets. Some stakeholders have concerns with the outcome of applying the fixed-for-fixed condition to these instruments.

31. In addition, as jurisdictions adopt IFRSs, there may be financial instruments with new features to which IFRSs will need to be applied for the first time or financial instruments

that were reported in a variety of ways in different jurisdictions to reflect local financial reporting.

32. The FICE project also aims to improve presentation and disclosure which, depending on the scope of any improvements, could require amendments to both IAS 1 *Presentation of Financial Statements* and IFRS 7 *Financial Instruments: Disclosures* in addition to IAS 32. The Board's intention is to further develop or modify some of the presentation and disclosure proposals in the 2018 DP to take into account the feedback received. The Board has also previously acknowledged that one possible outcome of the FICE project is a recommendation to add a project to amend the Conceptual Framework in relation to distinguishing between liabilities and equity.

Costs and benefits

33. Feedback on the 2018 DP indicated general support for standard-setting to address known practice issues but there were mixed views on the type of standard-setting that would be required. A few users of financial statements acknowledged that there will be a trade-off between costs (additional complexity) and benefits (additional transparency) in making changes to IAS 32. In the September 2019 Board meeting, the Board considered the advantages and disadvantages of five alternatives for the direction of the FICE project. The Board tentatively decided on an approach that addresses practice issues by clarifying some underlying principles in IAS 32. Under such an approach, the Board would have a clear starting point, ie the known application issues and accounting challenges raised by respondents over time as well as the requirements in IAS 32 (including existing and familiar terminology). There is potential for addressing future as well as existing challenges because the Board would be developing a principles-based solution.

34. In our view, the main benefits of the FICE project would be:

(a) a clearer articulation of some of the IAS 32 classification principles and their underlying rationale;

(b) improved consistency, completeness and clarity of the requirements for classification; and

(c) improved information provided through presentation and disclosures about features of financial liabilities and equity instruments not captured in the binary classification.

However, there will be incremental demands on resources for the Board to develop the clarifications and for stakeholders to implement them.

35. Consequently the staff's preliminary assessment, subject to a more detailed effects analysis which will be undertaken before issuing an Exposure Draft, is that the benefits of the improvements to financial reporting from this project are likely to outweigh the costs.

Project consultative group

36. The Due Process Handbook requires the Board to consider whether it should establish a consultative group for each major project it adds to its standard-setting programme. The objective of consultative groups is to give the Board access to additional practical experience and expertise. The Due Process Handbook states that it is not mandatory to have such a group, but if the Board decided not to have it, it must explain why on the project page and inform the Due Process Oversight Committee.[3]

37. The staff believe there is no need for a dedicated consultative group for the FICE project because:

(a) a dedicated consultative group would require a lot of additional time and resources which may slow down progress on the project;

(b) the staff can undertake targeted outreach where detailed specialist knowledge is required on particular issues; and

(c) the Board's existing consultative groups have the necessary practical experience and expertise on the classification, presentation and disclosure of financial instruments to advise on this project. We have already consulted extensively

[3] *Due Process Handbook*, paragraphs 3.59-3.60.

with ASAF, GPF and CMAC and plan to continue using these groups to provide advice on the project.

Questions

Question 1
Does the Board agree with the staff recommendation to move the FICE project from the research programme to the standard-setting programme?

Question 2
Does the Board agree with the staff recommendation that a consultative group is not needed for this project? If not, why?