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Financial Instruments with Characteristics of Equity

Cover Note

Objective

- 1 The objective of this session is to discuss with the EFRAG TEG the latest developments undertaken by the IASB with regards to the *Financial Instruments with Characteristics of Equity* ('FICE') project and next steps.

Introduction

- 2 The objective of the FICE project is to investigate potential improvements to:
 - (a) the classification of liabilities and equity in IAS 32 *Financial Instruments: Presentation*, including investigating potential amendments to the definitions of liabilities and equity in the Conceptual Framework; and
 - (b) the presentation and disclosure requirements for financial instruments with characteristics of equity, irrespective of whether they are classified as liabilities or equity.
- 3 The IASB is also currently making changes to the definition of a liability in the Conceptual Framework project. However, those changes address aspects of the definition of a liability that are not directly related to distinguishing between liabilities and equity and will not constrain the work in the FICE research project.

The IASB's approach to the project

- 4 In previous EFRAG TEG meeting, the most recent being February 2017, EFRAG TEG received updates on the IASB's approach to the project and covered the following topics:
 - (a) **the features of claims:** that are relevant for primary users of financial statements in making decisions about providing economic resources to the entity (i.e. type, amount, timing and priority of the claim) and the extent to which IAS 32 captures those features. This analysis formed the basis for the classification, presentation and disclosures of claims in the IASB's project;
 - (b) **improvements to the classification requirements:** the IASB identified three new approaches (Alpha, Beta and Gamma) that are candidates for potential improvements to IAS 32;
 - (c) **improvements to the presentation of financial instruments classified as liabilities:** the IASB considered the use of sub-classes of financial liabilities to provide additional information that a binary approach on classification cannot convey. More specifically, the IASB discussed the presentation of liabilities with different features on the face of the statement of financial position and the presentation of income and expenses that arise from different sub-classes

of liabilities in the statement of financial performance, including the use of other comprehensive income (OCI);

- (d) **improvements to the presentation of financial instruments classified as equity:** the IASB discussed how subclasses of equity could help in providing additional information about the features identified as relevant. This included discussions on whether subclasses of equity should include “ordinary shares” and “senior classes of equity”, whether the attribution of profit or loss and OCI should be expanded to senior classes of equity (and if so how) and whether the carrying amount of each subclass of equity should be updated to reflect the attribution of profit or loss and OCI;
 - (e) **derivatives on own equity:** the IASB discussed the application of the Gamma approach to different types of derivatives on own equity (including those whose classification under IAS 32 has been challenging in practice), the unit of account for accounting for derivatives on own equity and whether derivatives should be split into components for classification purposes. It also discussed the existing puttable instruments exception in IAS 32 and how the Gamma approach addresses some issues that arise in practice when applying the fixed-for-fixed condition in IAS 32;
 - (f) **claims with conditional alternative outcomes:** the IASB considered the challenges in accounting for claims with conditional alternative liability and equity settlement outcomes. For example, it considered whether the requirements in IAS 32 should be aligned with the “no commercial substance” principles included in paragraph 41 of IFRS 2 *Share-based Payment* and the Conceptual Framework ED and whether economic incentives that may influence the entity’s decision to exercise its option should be considered when classifying claims with alternative settlement outcomes; and
 - (g) **improvements to the disclosure requirements:** the IASB discussed improvements to disclosure requirements to provide information to users. This includes improvements to disclosures on priority of claims on liquidation and potential dilution of ordinary shares.
- 5 Agenda paper 10-02 covers the topics discussed by the IASB from February 2017 to March 2017, which include:
- (a) how the Gamma approach would apply to the accounting within equity;
 - (b) the scope of contractual rights and obligations to be considered for the classification and presentation requirements under the Gamma approach;
 - (c) application of the Gamma approach to the classification of derivatives on non-controlling interests with an exercise price denominated in a foreign currency; and
 - (d) a summary of interactions with other IFRS Standards, IFRIC Interpretations and the *Conceptual Framework for Financial Reporting*;
- 6 In March 2017 the IASB reviewed the due process steps it had taken in developing the FICE Discussion Paper (“DP”) and instructed the IASB Staff to begin drafting and balloting the DP. The DP will explore the advantages and disadvantages of alternative ways of making the distinction between equity and liability along with improvements in presentation and disclosure.
- 7 Based on the completion of that research, and the responses to that forthcoming Discussion Paper, the IASB will need to decide whether to add a project to its Standards-level programme to amend IAS 32 and whether any further changes are needed to the Conceptual Framework and other IFRS Standards.

Next steps

- 8 EFRAG Secretariat plans to bring in a future meeting illustrative examples focused on classification and presentation of financial instruments under the Gamma Approach and an assessment of how the practical issues that have been raised in the past (e.g. IFRS Interpretations Committee) are being addressed under the Gamma Approach.

Agenda Papers

- 9 In addition to this cover note, this session includes agenda paper 10-02 – *Issues paper on latest developments on FICE*.