Financial Instruments with Characteristics of Equity Issues Paper

Objective

1 The objective of this session is to provide an update to EFRAG Board members on the IASB Research Project *Financial Instruments with Characteristics of Equity* (FICE).

Introduction

2 The IASB's recent research project on FICE is a new round in a long debate on how to distinguish liabilities from equity instruments.

3 The IASB's discussions on this project started in May 2015 and lasted until January 2018. The next step of this project is the publication of a Discussion Paper expected in June 2018. Based on the responses to the forthcoming Discussion Paper, the IASB will need to decide whether to add a project to amend IAS 32 *Financial Instruments: Presentation* and whether any further changes are needed to the Conceptual Framework.

Why a project on FICE?

4 In the past, the IFRS Interpretations Committee ("IFRS IC") received several submissions related to the application challenges of IAS 32 and in many cases it was unable to reach a conclusion. The IFRS IC referred these issues to the IASB as the challenges identified required discussion of fundamental concepts in IFRS Standards.

5 The IASB tried to address the conceptual challenges related to the distinction between equity and liability within its Conceptual Framework project. However, given that the challenges are both practical and conceptual, the IASB decided to address these issues within the research project FICE, where both the conceptual and application issues are addressed together.

What are the key challenges that arise with IAS 32?

6 The key challenges can in general be classified as:

(a) *conceptual issues*: IAS 32 includes complex exceptions that override the definition of a liability in the Conceptual Framework, which make it inconsistent within itself and with other standards; and

(b) *application issues:* the lack of clarity in the existing guidance and the absence of guidance on some issues leads to divergence in practice, for example the application of the fixed-for-fixed condition to derivatives on own equity and the accounting for instruments for which the form and/or amount of the settlement depends on events beyond the control of the entity and the counterparty.

What is the scope of the FICE project?

7 To address these issues, the IASB discussed potential improvements to the classification, presentation and disclosure requirements of financial instruments under the scope of IAS 32, including the possibility of making amendments to the definitions of liabilities and equity in the Conceptual Framework.

IASB's key decisions to date

8 On the **classification** of FICE, the IASB focused on an approach that is generally consistent with IAS 32 ("Gamma approach") and will:

(a) provide additional guidance and clarify some complex areas such as the fixed-for-fixed condition to derivatives on own equity, the redemption obligation requirements and the accounting within equity;

(b) remove some exceptions (e.g. foreign currency rights issue exception); and

(c) affect the classification of only a few financial instruments such as non-redeemable preference shares.

9 At this stage the IASB has decided to retain IAS 32's so-called puttables exception, and also the guidance in IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments*, but remove IAS 32's foreign currency rights exception.

10 On the **presentation and disclosure** of FICE, the IASB tentatively decided to develop specific proposals that will apply to particular subclasses of liability and equity. These proposals are intended to address the limitations of a binary classification system under which instruments must be classified as either liabilities, equity (or as compound instruments), but may have characteristics of both. These requirements would in some cases represent a significant change to current requirements, for example:

(a) gains and losses on particular *subclasses of liability* would be presented in other comprehensive income (OCI). This would apply to subclasses for which the amount of the claim relates to the performance of the entity (e.g. gains or losses on shares redeemable at fair value such as certain NCI written puts);

(b) entities would have to have to remeasure some *subclasses of equity* (e.g. derivatives on own equity) through an attribution mechanism of comprehensive income. This remeasurement will be made within equity.

11 On **disclosures** of FICE**,** the Discussion Paper is expected to include a discussion on disclosures about the priority of claims on liquidation, the potential dilution of ordinary shares and other additional information about FICE.

Importance of this project and what may change

12 The distinction between liabilities and equity is of great importance because it affects, for example, gearing (leverage) and solvency ratios, which may result in a breach of debt covenants and may be important if the company is required by law to maintain a certain level of equity.

13 When considering the IASB's discussion, the EFRAG Secretariat assessed that the most significant impacts will include:

(a) the effect of the proposed presentation requirements for particular subclasses of liability and the attribution of comprehensive income among particular subclasses of equity;

(b) change in the classification of financial instruments that currently meet the foreign currency rights exception in paragraph 16 of IAS 32 (classified as a liability with related returns presented potentially in OCI instead of the present classification under IAS 32 as equity); and

(c) change in the classification of non-redeemable cumulative preference shares and perpetual cumulative hybrid securities that currently are classified as equity in their entirety (reclassification from equity to liability).

14 These changes are likely to affect banks, insurance companies and other entities that issue complex financial instruments. Thus, regulators will need to consider the impact of the FICE project and the relation with regulatory requirements for financial institutions, particularly on capital requirements that are closely related to the classification of financial instruments under IFRS Standards.

15 Currently it is difficult to assess the full impact of the Gamma approach on the market as there is insufficient information about the different instruments classified as equity. In addition, the classification of financial instruments under the Gamma approach might also depend on the behaviour of entities when faced with the new requirements in terms of changing the structure of the financial instruments to achieve a particular classification outcome.

16 As the IASB tentatively decided to retain the puttables exception and IFRIC 2, the EFRAG Secretariat expects that the accounting for financial instruments classified as equity for mutual funds, unit trusts, limited-life entities, co-operatives and similar entities will not be affected.

What has EFRAG been doing since the beginning of the project?

17 The EFRAG Secretariat has been regularly providing updates to EFRAG TEG and their working groups (EFRAG User Panel and EFRAG Financial Instruments Working Group). More recently, EFRAG TEG discussed a high level preliminary impact assessment developed by the EFRAG Secretariat.

18 Many EFRAG TEG members considered that IAS 32 is not fundamentally broken. However, they noted that new instruments developed after the financial crisis (e.g. contingently convertible bonds and mandatorily convertible bonds with a cap and floor) are stretching the current requirements to their limits. Thus, they supported the IASB's efforts to address the current application issues and conceptual issues related to IAS 32 and clarify its principles in the process.

19 In particular, EFRAG TEG members welcomed improvements to current presentation and disclosures requirements as a way to address the existing significant differences between equity and liability classification in terms of presentation and measurement.

20 Nonetheless, some members expressed concerns about the clarity of some of the proposed new terminology and the risk of increased complexity.

Question for the EFRAG Board

21 Do EFRAG Board members have any specific concern or comment on the FICE project at this stage?