Financial Instruments with Characteristics of Equity
Cover Note

Objective

1 The objective of the meeting is to discuss the:

(a) direction of the project, which will set the direction for the IASB's redeliberations; and

(b) objectives and criteria set out by the IASB Staff to determine the scope of the project.

Agenda Papers

2 In addition to this cover note, agenda papers for this session are:

(a) Agenda paper 10-02 – ASAF 01 FICE Direction of the project; and

(b) Agenda paper 10-03 – Feedback received by the IASB – for background only.

Introduction

3 Since March 2019 the IASB has been considering the feedback received on the different sections of the IASB's Discussion *Paper Financial Instruments with Characteristics of Equity* (DP) (agenda paper 10-03 contains a summary).

4 At its September 2019 meeting the IASB will discuss the direction of the FICE project and consider different alternatives, including the pros and cons of each alternative and indicative timelines.

Project direction alternatives

5 A clear message heard from the IASB's public consultation is that there is support for the IASB to undertake some form of standard-setting to address the existing diversity in practice and application challenges - even though the preferred direction of standard-setting varied amongst respondents.

6 Based on the IASB staff analysis of the feedback received, the IASB staff identified the following five alternatives for the direction of the FICE project.

Alternative A - Fundamental review	Under this approach, the IASB would undertake a fundamental review to develop a new approach to distinguish financial liabilities from equity instruments. It would be a fresh start approach leveraging on the feedback received.

Alternative B – IASB's preferred approach in the DP (but modified)	Under this approach, the IASB would proceed with its preferred approach set out in the DP (classification principles based on the timing and amount features) subject to some clarifications or modifications based on the feedback received (e.g. clarification of terms and principles used by the IASB to describe the classification principles or reconsider how the amount feature assessment should apply to obligations that arise only on the issuer's liquidation).
Alternative C - Clarifying amendments to IAS 32	Under this approach, the IASB would focus on addressing the issues that arise in practice by clarifying the underlying principles of IAS 32. For example, the IASB could consider adding an explanation of the objective of the current requirements in IAS 32 and adding new application guidance. The IASB could also consider clarifying the interactions between different requirements in IAS 32. Developing such amendments to IAS 32 would involve a bottom-up approach in which the IASB would start by considering which accounting challenges need to be addressed and then focus on clarifying the underlying principles in IAS 32 that are necessary to address those accounting challenges.
Alternative D - Narrow-scope amendments to IAS 32	This approach would involve adding or modifying requirements in IAS 32 for a specific fact pattern or a specific feature of financial instruments without clarifying existing principles or underlying rationales. This alternative could involve adding application guidance or introducing exceptions to the requirements in IAS 32.
Alternative E - Disclosure-only project	This approach would involve refining the disclosure proposals in the DP assuming classification requirements remain unchanged from IAS 32. Having the disclosure project as a separate project would not necessarily prevent the IASB from undertaking a classification project (long-term).

7 All of these alternatives would include consideration of improvements related to both presentation and disclosure (e.g. existing IFRS 7 disclosures can be improved, especially disclosures for equity instruments). Alternatives A-D above would also consider:

(a) matters submitted to the IFRS Interpretations Committee (the IFRS IC) which the IFRS IC decided not to add to its agenda because they would be considered in the FICE project;

(b) relevant IFRS IC discussions and agenda decisions; and

(c) additional application and/or conceptual matters that were highlighted by respondents to the DP.

8 The IASB Staff is of the view that the objectives of the DP remain appropriate but suggested that the IASB could consider another approach to achieve those objectives. That is, the IASB staff suggested that the IASB could consider clarifying underlying principles in IAS 32 to address the 'problem areas without causing unintended consequences or new diversity (**support for Alternative C**).

9 To help the IASB determine the scope of the project, the IASB Staff suggested the following **criteria to assess which issues should be addressed**:

(a) those that have a widespread effect and have, or are expected to have, a material effect on those affected;

(b) where financial reporting would be improved through a change in the required classification or through the elimination, or reduction, of diverse reporting methods that result from a lack of clarity in the IAS 32 requirements or insufficient application guidance; and

(c) that can be resolved efficiently and effectively within IAS 32 and its underlying principles (ie not confined to the existing classification requirements as written in IAS 32).

10 In addition, the IASB Staff suggested that the **objective of Alternative C** should be to (paragraph 35 of agenda paper 10-02):

(a) improve the information entities provide in their financial statements about financial instruments that they have issued (as in the IASB's DP);

(b) limit the changes to the classification requirements in IAS 32 to those that are necessary because there is diversity in practice or sufficient evidence that a change in the classification outcome would lead to more useful information;

(c) ensure the amendments do not create new internal consistencies in IAS 32;

(d) finalise the amendments in a timely manner; and

(e) consider a transition approach that will limit implementation costs.

EFRAG Secretariat analysis

11 In its comment letter on the DP, EFRAG rejected the IASB's preferred approach for classification and suggested potential targeted improvements to IAS 32 (EFRAG Comment Letter here).

12 EFRAG acknowledged that some constituents were calling for a more conceptual approach to distinguishing debt from equity. However, during its consultation period, EFRAG did not identify any consensus on how to achieve this in a reasonable timeframe. Therefore, developing a more conceptual and less rules-based approach would be very challenging and any alternative that results in widespread classification changes is likely to prove controversial (as with previous approaches discussed by the IASB and EFRAG).

13 A large proportion of respondents to the IASB's DP supported a so-called 'targeted improvements to IAS 32' as these respondents did not consider that IAS 32 was broken beyond repair (EFRAG Feedback Statement here and Feedback Received by the IASB in agenda paper 10-03).

14 Therefore, the EFRAG Secretariat considers that **Alternative C** seems to be the most aligned with the EFRAG position stated in its comment letter, which highlighted the importance of addressing the issues that arise in practice in a timely manner.

15 The EFRAG Secretariat considers that the objectives and criteria developed by the IASB Staff are useful to define the scope and direction of the project. We also understand the IASB Staff's concern about including issues in the scope that would require fundamental changes to the current requirements in IFRS Standards (e.g. classifying all derivatives as financial assets or financial liabilities).

16 However, the EFRAG Secretariat considers that it would not be useful to exclude issues from the scope of the project just because they cannot be resolved efficiently and effectively within IAS 32 and its underlying (clarified) principles. In our view, the IASB may not only clarify the existing principles but, if necessary and when there is lack of guidance (e.g. written puts over non-controlling interest), add new principles to address the issues that arise in practice.

Questions for EFRAG TEG/CFSS

17 Does EFRAG TEG/CFSS agree with the IASB Staff recommendation on the direction of the project (Alternative C – Clarifying amendments to IAS 32)?

18 If do, does EFRAG TEG/CFSS agree with the objectives and criteria to determine the scope of the project as described in paragraph 9 and 10 above?