# Financial Instruments with Characteristics of Equity
# Cover Note

## Objective

1 The objective of the session is to provide:

- (a) an update on the IASB's discussions on the IASB's project *Financial Instruments with Characteristics of Equity* (FICE); and
- (b) obtain EFRAG TEG-CFSS members views on some of the IASB's tentative decisions to date, in particular:
  - (i) Financial instruments with contingent settlement provisions, and
  - (ii) Effects of laws on the contractual terms

2 In addition to this cover note, agenda paper 10-02 – *IASB Agenda Paper AP6* has been provided for the session or, if there are more than two agenda papers.

## Background

3 The IASB's research project in 2018 on *Financial Instruments with Characteristics of Equity* was a new round of a long debate on how to distinguish liabilities from equity instruments. The IASB has finalised its discussions and issued a Discussion Paper on 28 June 2018. For more details on this project please click here.

4 After considering feedback on its Discussion Paper, the IASB tentatively decided to explore making clarifying amendments to IAS 32 *Financial Instruments: Presentation* to address common accounting challenges that arise when applying IAS 32. The IASB also intends to further develop some of the presentation and disclosure proposals included in the Discussion Paper.

5 In December 2020 the IASB agreed to move the FICE project from the research programme to the standard-setting programme. The next milestone of this project is an Exposure Draft.

6 The key topics discussed by the IASB can be found below:

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| **Analysis of the feedback received on the DP**<br><br>*IASB March – July 2019* | • The IASB discussed the feedback received from stakeholders on the Discussion Paper *Financial Instruments with Characteristics of Equity.* |
| **Project Direction**<br><br>*IASB September 2019 and December 2020* | • The IASB discussed the direction of the project and tentatively decided on an approach that addresses practice issues by clarifying some principles in IAS 32. |

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| | • The IASB discussed whether it should move the project from the research programme to the standard-setting programme and decided to add this project to its standard-setting programme. |
| **Project Plan**<br>*IASB October 2019* | • The IASB discussed the project plan, including a list of practice issues that could be addressed as part of the project. |
| **Classification:** financial instruments settled in own equity instruments: fixed for fixed<br>*IASB December 2019 – April 2020* | • The IASB explored potential clarifications to the underlying principle for classifying derivatives on own equity and tentatively decided that for a derivative on own equity to meet the fixed-for-fixed condition in IAS 32, the number of functional currency units to be exchanged with each underlying equity instrument must be fixed or only vary with allowable preservation adjustments or allowable passage of time adjustments.<br>• In addition, the IASB tentatively decided to classify as equity a contract that can be settled by exchanging a fixed number of non-derivative own equity instruments with a fixed number of another type of non-derivative own equity instruments.<br>• It also tentatively decided to provide guidance on the meaning of adjustments arising from preservation and passage of time. |
| **Disclosures**<br>*IASB March 2019 - May 2021* | • The IASB discussed potential refinements to the disclosures proposed in the DP FICE. For that purpose, the IASB considered the feedback from stakeholders on its proposals included in the ED, the feedback received in additional outreaches activities focused on disclosures and the IASB's staff research on regulatory disclosures provided by banks and insurers.<br>• These potential refinements were focused on disclosures on priority on liquidation; potential dilution and terms and conditions. |
| **Classification**: Financial instruments with contingent settlement provisions<br>*IASB November 2021 – February 2022* | • The IASB discussed the accounting for financial instruments that contain contingent settlement provisions, including:<br>○ classification and measurement of financial instruments with Contingent settlement provisions, including compound financial instruments (December 2021);<br>○ recognition of discretionary dividends (December 2021);<br>○ the meaning of 'liquidation' and 'non-genuine' (December 2021);<br>○ shareholder discretion (February 2022). |
| **Classification**: the effects of laws on contractual terms<br>*IASB September 2021 – December 2021* | • The IASB discussed to what extent, an entity should be required to treat a legal requirement or a term that is required by law as part of the contractual terms. |
| **Reclassification:**<br>*IASB March-June 2022* | • The IASB explored what clarifications could potentially be made to IAS 32 on reclassification between financial liability and equity instruments. |

### Contingent settlement provisions: compound financial instruments

7 After the 2008 global financial crisis, there has been an increase in the number of instruments issued by financial institutions that have loss absorption features using a contingent conversion mechanism. These instruments may have discretionary

dividend features, which brings into question whether these instruments are compound instruments containing both equity and liability components.

8 Many issues related to contingent settlement provisions have been discussed by the IFRS Interpretations Committee (IFRS IC) in the past. In particular, the IFRS IC discussed the classification of a **financial instrument that is mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event** (bail-in instruments). This includes discussions on how an entity accounts for any subsequent discretionary distributions on these types of compound instruments.

9 At the time, the IFRS IC discussed five different alternative views that were being applied in practice (e.g. the instrument is classified as a liability in its entirety; or the instrument is a compound instrument; or the instrument is a compound instrument but the equity component has a value of zero).

10 The IFRS IC ended up deciding that it would not add this issue to its agenda. The IFRS IC noted that the scope of the issues raised in the submission was too broad for it to address in an efficient manner.

11 In September and December 2021, the IASB discussed the following potential clarifications to address the issues that arise in practice:

(a) *The order of applying the requirements in IAS 32*: When a compound financial instrument contains contingent settlement feature, the question that arises in practice is whether there is a required sequence for applying paragraphs 25 (requirements for contingent settlement provisions) and 28 (requirements for compound instruments) of IAS 32. This is because the classification outcome could differ depending on which requirements are applied first (either classified as a financial liability in its entirety or as a compound instrument comprised of a liability component and an equity component).

(i) ***Potential clarifications***: require the compound instrument requirements (paragraphs 28-32 of IAS 32) apply first to identify the components of the financial instrument before any specific classification requirements.

(b) *Impact of probability on measurement*: the question that arises in practice is whether and how probability of the contingent event occurring should affect the measurement of the financial instrument (i.e., whether the liability that arises from financial instruments containing contingent settlement provisions should be measured at the full amount or at probability-weighted amount taking into account the likelihood and timing of the contingent event).

(i) ***Potential clarifications***: require full amount of the conditional obligation for instruments with contingent settlement provisions, which would be the amount repayable assuming the earliest possible repayment date

(c) *Discretionary payments*: the question that arises in practice is how to account for discretionary interest or dividend payments if the entire proceeds are allocated to the liability component of a compound instrument.

(i) ***Potential clarifications***: clarify that a compound instrument with a zero-value equity component is still a compound instrument with a liability (measured at the full amount that the issuer could be required to pay immediately) and an equity component (residual, which is zero). Thus, if the issuer pays any discretionary interest, those payments relate to the equity component and would be recognised in equity.

12 After considering the issues that arise in practice related to contingent settlement provisions, <u>the IASB in December 2021 tentatively decided to propose amendments to IAS 32</u>:

(a) to clarify that financial instruments with contingent settlement provisions may be compound instruments;

(b) to clarify that the liability component of a compound financial instrument with contingent settlement provisions, which could require immediate settlement if a contingent event occurs, is measured at the full amount of the conditional obligation; and

(c) to clarify that payments at the discretion of the issuer are recognised in equity, even if all the proceeds are initially allocated to the liability component of a compound financial instrument.

*EFRAG Secretariat Analysis*

13 The EFRAG Secretariat welcomes the IASB's discussions on contingent settlement provisions. The IASB's discussions are aligned with EFRAG request to the IASB to further work in this area.

14 The EFRAG Secretariat also welcomes the direction of travel of the IASB's clarifications in this area, which have the benefit of being aligned with the IFRS IC previous discussions on this topic. Such clarifications will have the benefit of ensuring consistency on the measurement and presentation of the liability and equity components and consistency on the discretionary interest payments. It has also the benefit of not representing a significant change to current requirements in IAS 32 (only clarifications).

15 On the liability component, if the IASB were to require the measurement of such liabilities at a probability-weighted amount, significant judgement would be required and continuous reassessment would be needed if, and when probabilities change over time. Furthermore, it would require reconsideration of other provisions in IAS 32 that require liability treatment for obligations that are conditional on events or choices that are beyond the entity's control (e.g., the treatment of puttable instruments that give the holder the right to put the instrument back to the issuer for cash or another financial asset).

16 On the equity component, the EFRAG Secretariat notes that the IASB's tentative decision on recognising any interest paid in equity represents a change to some entities that currently present them in profit or loss and apply hedging accounting. In addition, disclosures may be necessary to clarify users of financial statements of why payments are presented in equity.

**Contingent settlement provisions: the meaning of 'liquidation' and 'non-genuine'**

17 In September and December 2021, the IASB discussed the following potential clarifications to address the issues that arise in practice:

(a) *The meaning of liquidation*: The question that arises in practice is how to interpret the meaning of 'liquidation' in paragraph 25(b) of IAS 32 in the context of processes that are similar to liquidation.

(i) ***Potential clarification***: specify that the term 'liquidation' in paragraph 25(b) of IAS 32, refers to when an entity has started the process to permanently cease to trade.

(b) *The meaning of non-genuine:* The question that arises in practice is how to interpret the meaning of 'non-genuine' in paragraph 25(a) of IAS 32[1]. That is whether 'non-genuine' is a wider notion that considers the purpose for including such features in the terms of the instrument even if that contingent event is extremely rare, highly abnormal or very unlikely to occur.

[1] Paragraphs 25 and AG28 of IAS 32 state that a contingent settlement feature does not affect classification if that feature is 'not genuine'. A contingent settlement feature is not genuine if the occurrence of the uncertain future event is extremely rare, highly abnormal and very unlikely to occur.

(i) ***Potential clarification***: clarify that the non-genuine assessment in paragraph 25(a) of IAS 43 is not purely a probability-based assessment. This would clarify that entities are required to apply judgement base on the specific facts and circumstances and the specific terms and conditions of the financial instrument. Thus, if a feature that would be regarded as non-genuine because the contingent event is extremely rare, highly abnormal and very unlikely to occur, could still be regarded as genuine when there is a specific purpose for it to be in the contract.

18 After considering these two issues, <u>the IASB in December 2021 tentatively decided to propose amendments to IAS 32</u>:

(a) to specify that the term 'liquidation' in paragraph 25(b) of IAS 32 refers to when an entity is in the process of permanently ceasing operations; and

(b) to specify that an assessment of whether a contract term is 'not genuine' under paragraph 25(a) of IAS 32 is not made by considering only the probability of the contingent event occurring.

*EFRAG Secretariat Analysis*

19 The EFRAG Secretariat welcomes additional guidance on the meaning of liquidation, which seems to be in line with the conceptual framework. The IASB's clarification has the benefit of bringing consistency and reducing diversity in practice to the classification of financial instruments that contain obligations that arise on events that may seem similar to, but are not, liquidation (e.g., resolution, restructuring, pre-determined liquidation, etc).

20 Nonetheless, considering that different jurisdictions have different requirements for the liquidation process, the IASB should clearly explain the meaning of 'process of permanently ceasing operations', provide some examples and test it in practice.

21 The EFRAG Secretariat also welcomes the additional guidance on the meaning on non-genuine in IAS 32, stating that an event may still be regarded as genuine when there is a specific purpose for including it in the contract (terms may be included in a contract for genuine commercial, regulatory or tax purposes despite the likelihood of such an event to occur being extremely low).

22 This is particularly relevant for financial instruments that are mandatorily convertible into a variable number of shares upon a contingent non-viability event (breach of Tier 1 Capital ratio). Although a non-viability event may be unlikely to occur, it is difficult to argue that such feature is non-genuine when there is a specific purpose for including the contingent non-viability event in the contract.

23 Still, the EFRAG Secretariat considers that the IASB could consider some indicators that would help the assessment of whether a contingent settlement provision is not genuine, such as having no economic substance, no commercial substance or unrealistic.

24 The IASB could also consider bringing more alignment between the indirect obligation requirements (paragraph 20 of IAS 32) and the contingent settlement provisions (paragraph 25 of IAS 32).

25 Finally, the EFRAG Secretariat suggests that the IASB considers the terms 'liquidation' and 'non-genuine' together with other related terms such as 'going concern' and 'not substantive', which can be found in other IFRS Standards.

**Questions for EFRAG FR TEG**

26 In your view, would the IASB's tentative decisions on financial instruments with contingent settlement provisions:

- resolve practice issues?
- have any unintended consequences?

27 Do EFRAG FR TEG members have any other comments on the IASB tentative decisions or EFRAG Secretariat analysis?

## The effects of laws on contractual terms

28 Understanding the meaning of 'contractual' is a critical element for classification of a financial instrument as a financial liability or an equity instrument.

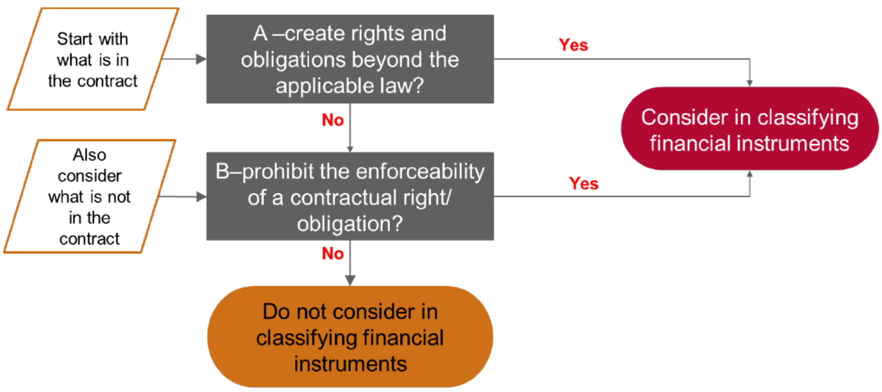
29 The overarching question is whether, and if so to what extent, a legal requirement is part of the contractual terms and must therefore be considered in classifying a financial instrument as a financial liability or an equity instrument. In particular, whether a legal requirement that is not reproduced or referred to in the contract but is implied by law is part of the contractual terms. This is particularly relevant for instruments such as bail-in instruments, ordinary shares with statutory minimum dividends and mandatory tender offers.

30 Currently IFRS Standards are not consistent when dealing with the 'contractual rights and obligations' and 'regulatory and legal' requirements. The 2018 DP proposed no changes to IAS 32 on this topic. Some respondents who agreed with the IASB's view noted that taking into consideration the overall effects of laws would represent a significant change to current requirements and could have unintended consequences. However, most respondents urged the IASB to provide guidance on what should be considered as part of the contractual terms and whether, and how, an entity should consider the effects of relevant laws in classifying financial instruments.

31 The IASB is exploring potential guiding principles to help determine whether legal requirements or terms that are required by law should be regarded as part of the contractual terms, regardless of whether being explicitly stated in the contract, and should be considered for classification purposes. More specifically, the IASB discussed the following potential principles approach:

(a) an entity should consider for classification purposes only the terms explicitly stated in the contract that give rise to rights and obligations that are in addition to, or more specific than, those established by applicable law; and

(b) an entity should consider for classification purposes the effects of applicable laws that prohibit the enforceability of a contractual right or a contractual obligation.



32 Thus, in classifying financial instruments under IAS 32, an entity would need to disregard some legal requirements even if they are stated in the contract. By contrast, an entity would need to consider some other legal requirements even if they are not stated in the contract. For example:

(a) *Principle A*: if local law requires all companies to distribute a minimum 10% of the profit as dividends to shareholders, then the terms in a contract stating that the company is required to distribute the legal minimum of 10% of profits does not create any additional obligation for the entity than what is already required by law. Thus, such terms should not be considered for classification purposes.

(b) *Principle B*: for an IFRIC 2-type instrument whose redemption is prohibited by law, the legal requirement prohibits an existing contractual obligation (i.e. the issuer's obligation to redeem the instrument). The legal requirements make the redemption obligation unenforceable, then such a legal prohibition would be treated as part of the contractual terms and would be considered for classification purposes.

33 After discussing possible improvements to IAS 32, <u>the IASB tentatively decided to propose amendments to IAS 32 to require an entity to classify financial instruments as financial liabilities or equity by considering</u>:

(a) terms explicitly stated in the contract that give rise to rights and obligations that are in addition to, or more specific than, those established by applicable law; and

(b) applicable laws that prevent the enforceability of a contractual right or a contractual obligation.

*EFRAG Secretariat Analysis*

34 The EFRAG Secretariat welcomes the IASB's discussions on the effects of law and regulation. The IASB's discussions are aligned with EFRAG request to the IASB to further work on the interaction between the terms and conditions of a contract and legal requirements to avoid a blanket rejection of the effects of the law from classification.

35 In particular, when considering bail-in instruments where different jurisdictions face challenges on how to take into account the interaction between the contractual rights and obligations and regulation (such as the Bank Recovery and Resolution Directive (BRRD)) when classifying these instruments.

36 Considering the challenges that arise in practice, particularly with bail-in legislation, we welcome the IASB's tentative decision on potential guidance that may assist entities in addressing these issues. Nonetheless, the EFRAG Secretariat considers that some testing should be made in the future to avoid unintended consequences, in particular to instruments that require the distribution of a particular percentage of its profits by law.

37 Although leaving open some structuring opportunities, the EFRAG Secretariat is currently not in favour of an all-inclusive approach (i.e. strict legal approach) as taking into consideration the overall effects of regulation and legislation in the classification model would represent a significant change to current requirements and could have unintended consequences.

38 When the IASB discussed Mandatory Tender Offers in October 2019 and September 2021, the IASB noted that solving the mandatory tender offers issue would require a fundamental re-write of IAS 32 and would be beyond the scope of the current project. Thus, EFRAG Secretariat considers that the IASB's discussions do not seem to solve the issue of mandatory tender options. In its comment letter, EFRAG identified this as a relevant issue and had requested the IASB to address this issue in the future.

39 Finally, EFRAG welcomes that the IASB does not intend to reconsider the requirements in IFRIC 2 given that IFRIC 2 was developed for a very specific fact pattern with limited effect in practice and that it is not aware of any challenges to its application.

**Questions for EFRAG FR TEG-CFSS members**

40 In your view, would the IASB's tentative decisions on the effects of laws on the contractual terms

- resolve practice issues?
- have any unintended consequences?

41 Do EFRAG FR TEG-CFSS members have any other comments on the IASB tentative decisions or EFRAG Secretariat analysis?