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Financial Instruments with Characteristics of Equity Cover Note

Objective

- 1 The objective of the session is to provide an update on the IASB's latest tentative decisions on its project *Financial Instruments with Characteristics of Equity*.
- 2 In particular, to discuss:
 - (a) *The presentation of equity instruments*: how to mitigate the concerns raised by stakeholders about the limited information an entity provides in its financial statements about equity instruments it has issued (see questions in paragraph 25 and 26 of issue paper 07-02);
 - (b) *The presentation of liability instruments*: how to mitigate the concerns raised by stakeholders relating to a subset of financial liabilities subsequently measured at fair value through profit or loss, applying IFRS 9 *Financial Instruments* (whether the changes in the carrying amount of the financial liability should be presented in profit or loss or equity when the financial liability contains a contractual obligation to pay the holder an amount based on the entity's performance or changes in the entity's net assets) (see questions in paragraph 39 and 40 of issue paper 07-02); and
 - (c) *Sweep issues*: on classification and presentation topics included in the *Financial Instruments with Characteristics of Equity* (FICE) project plan (see questions in paragraph 28 and 29 of issue paper 07-03).

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 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 in practice 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.
- 6 **The next milestone of this project is an Exposure Draft, which is expected in the second half of 2023.**
- 7 The key topics discussed by the IASB can be found below:

<p>Analysis of the feedback received on the DP <i>IASB March – July 2019</i></p>	<ul style="list-style-type: none"> The IASB discussed the feedback received from stakeholders on the Discussion Paper <i>Financial Instruments with Characteristics of Equity</i>.
<p>Project Direction <i>IASB September 2019 and December 2020</i></p>	<ul style="list-style-type: none"> 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. 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.
<p>Project Plan <i>IASB October 2019</i></p>	<ul style="list-style-type: none"> The IASB discussed the project plan, including a list of practice issues that could be addressed as part of the project.
<p>Classification: financial instruments settled in own equity instruments: fixed for fixed <i>IASB December 2019 – April 2020</i></p>	<ul style="list-style-type: none"> 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. 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. It also tentatively decided to provide guidance on the meaning of adjustments arising from preservation and passage of time.
<p>Disclosures <i>IASB March 2019 - May 2021</i></p>	<ul style="list-style-type: none"> 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. These potential refinements were focused on disclosures on priority on liquidation; potential dilution and terms and conditions.
<p>Classification: Financial instruments with contingent settlement provisions <i>IASB November 2021 – February 2022</i></p>	<ul style="list-style-type: none"> The IASB discussed the accounting for financial instruments that contain contingent settlement provisions, including: <ul style="list-style-type: none"> classification and measurement of financial instruments with Contingent settlement provisions, including compound financial instruments (December 2021); recognition of discretionary dividends (December 2021); the meaning of ‘liquidation’ and ‘non-genuine’ (December 2021); shareholder discretion (February 2022).
<p>Classification: the effects of laws on contractual terms <i>IASB September 2021 – December 2021</i></p>	<ul style="list-style-type: none"> 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.

<p>Reclassification: <i>IASB March-June 2022</i></p>	<ul style="list-style-type: none"> • The IASB explored what clarifications could potentially be made to IAS 32 on reclassifications between financial liability and equity instruments.
<p>Obligations to redeem own equity instruments <i>IASB July-September 2022</i></p>	<ul style="list-style-type: none"> • The IASB met in July and September 2022 to discuss the accounting for financial instruments containing obligations for an entity to redeem its own equity instruments, including written put options on non-controlling interests. The IASB discussed problems that arise when entities apply paragraph 23 of IAS 32. The IASB also discussed possible clarifications it could develop to help resolve these problems.
<p>Presentation of equity instruments and of financial liabilities IASB December 2022 – February 2023</p>	<ul style="list-style-type: none"> • The IASB met in December 2022 and February 2023 to discuss: <ul style="list-style-type: none"> ○ <i>Presentation of equity instruments</i>: in particular, the presentation of equity instruments other than ordinary shares or perpetual instruments. ○ <i>Presentation of liability instruments</i>: discussed a subset of financial liabilities subsequently measured at fair value through profit or loss, applying IFRS 9 Financial Instruments
<p>Sweep issues on the classification and presentation in the FICE project plan</p>	<ul style="list-style-type: none"> • The IASB met in December 2022 and February 2023 to discuss Sweep issues on the classification and presentation in the FICE project plan, including: <ul style="list-style-type: none"> ○ Fixed-for-fixed condition; ○ Reclassification; ○ The effects of laws on the contractual terms; ○ Obligations to redeem own equity instruments; ○ Instruments containing contingent settlement provisions; ○ Presentation of financial liabilities containing contractual obligations to pay amounts based on the entity's performance or changes in the entity's net assets.

8 The last time EFRAG FR TEG members discussed this topic was on 9 November 2022.

Feedback received from EFRAG Working Groups

EFRAG Financial Instruments Working Group

9 In January 2020, November 2021, May 2022 and October 2022 EFRAG FIWG members received an update on the project and provided the following feedback:

- (a) agreed with the general project direction taken and with the identification of practice issues. Members observed that these issues are sometimes interrelated, e.g. NCI puts, the fixed-for-fixed criterion and the existence of discretion. In addition, they expected that the discussion will probably require revisiting existing interpretations such as IFRIC 2 and would appreciate if the project could also include implications to other standards driven by equity classification such as IAS 33 and measurement of financial liabilities arising from puttable instruments.

Fixed-for-fixed requirement

- (a) Generally, members supported the IASB's proposed approach and that the principles captured current practice, however it was noted that the final

wording for the passage-of-time adjustment may be central for the acceptance or not of the proposals.

- (b) Some members observed that the IASB's example where strike price is CU 100, CU 150 and CU 500 at the end of each of three years respectively seemed to indicate a change in practice as currently in their view such instrument would meet the fixed-for-fixed requirement. They did not have a view as to whether the proposed accounting would be an improvement or not.
- (c) While allowing a benchmark rate adjustment would introduce some variability, some considered that a variable rate could be considered to meet the fixed-for-fixed requirement under the passage-of-time adjustment proposals as these are phrased in terms of present value.
- (d) One member also referred to an equity rate swap where dividend streams are swapped for interest rates where the funding for the equity may be variable in nature, and this should still qualify as fixed for fixed.

Disclosures

- (a) *Liquidation*: companies prepare financial statements on a going concern basis and real-life situations can be more complex than simply liquidation. In particular, for regulated financial entities, the issue can be more related to a 'resolution' than to 'liquidation'. The EU regulation is focused on avoiding the liquidation, which is really the last step. Therefore, focusing simply on liquidation without considering resolution, the financial statements will not reflect the complexity of a financial institution.
- (b) *Liquidation*: for non-financial institutions such disclosures were relevant, although not directly related to resolution/liquidation. For example, there were many events that took place before liquidation, such as change of control or initial public offering, where this information was also useful.
- (c) *Contractually subordinated*: entities can face challenges determining whether priority stem from the contract or from related law/regulation. For example, in Sweden payments to government have higher priority, therefore, all other liabilities are subordinated, regardless of what is in the contract. In addition, financial institutions have difficulties in making the assessment on priority due to the interaction between the contractual rights and obligations and regulation. Hence, disclosures should consider both legal and contractual priority.
- (d) *Contractually subordinated*: there are other areas of complexity that should be considered such as the legal structure of international groups. Whether or not an instrument is secured or subordinated, it will depend on regulatory requirements and local legislation. The legal framework may change depending on the jurisdiction on where the instruments have been issued. Therefore, it may be useful to provide information based on subgroups if they are located in different jurisdictions (with different local legal requirements) and information on how the structure of the group affects priority.
- (e) Disclosures to be made on debt-like and equity-like features: considered that it was key to define debt-like features or equity-like features or to provide additional guidance as in practice it may be difficult to assess whether instruments will be in scope of the disclosures.
- (f) Finally, members suggested that the IASB should organise a field-test focused on disclosures once it has finalised the discussions on disclosures.

Contingent settlement provisions: compound instruments

- (a) welcomed the IASB's tentative decision to clarify the accounting for compound financial instruments with contingent settlement provisions and noted that the clarifications seemed to be fairly aligned with current practice and current requirements in IAS 32 (e.g. paragraph BC12 of the Basis for Conclusions of IAS 32 which refers to the treatment of financial instruments with contingent settlement provisions as financial liabilities for the full amount of the conditional obligation).
- (b) on the liability component of a compound financial instrument with contingent settlement provisions, members agreed that it should be measured at the full amount of the obligation, even if IFRS 9 currently requires a financial liability to be recognised at fair value on initial recognition. Measuring the financial liability component at the full amount would provide relevant information to users (i.e. would reflect that immediate settlement may be required) and would only be applicable to the liability component of a compound financial instrument with contingent settlement provision. In addition, member considered that measuring a liability at a probability-weighted amount taking into account the likelihood and timing of the contingent event would:
 - (i) be a significant change to current requirements (and not simply a clarification);
 - (ii) add complexity to the measurement calculation and additional costs to preparers;
 - (iii) involve significant judgement and continuous reassessment. This would also lead to instability and volatility in the statement of financial position (e.g. on ratios like equity/debt) and statement of profit or loss;
 - (iv) for bail in instruments, it would impact negatively the statement of profit or loss and the statement of financial performance in the worst possible moment (i.e., the liability would have to be recognised when the non-viability event becomes probable).
- (c) on the zero-value equity component, members considered that disclosure requirements may be needed for users to understand why payments are recognised as dividends.
- (d) acknowledged that if the payments at the discretion of the issuer are recognised in equity, then an entity cannot hedge the interest payments made in a foreign currency. This could be a problem for entities that issue these instruments in a currency that is different from its functional currency. This may have to be addressed in the Post-Implementation Review of IFRS 9 *Financial Instruments*.

Contingent settlement provisions: meaning of liquidation and non-genuine

- (a) on the meaning of liquidation, considering that different jurisdictions have different requirements for the liquidation process, the IASB should clearly explain the meaning of 'process of permanently ceasing operations'.
- (b) one member noted that the process of permanently ceasing operations may take years and it may be better to be closer to a dissolution event (i.e., the legal entity stops to exist).
- (c) on the meaning of non-genuine, it might be useful to link this clarification to the concepts of 'not being legally enforceable' and 'not substantive'. The latter was considered by the IFRS Interpretation Committee when discussing the classification of a financial instrument that is mandatorily convertible into a variable number of shares (subject to a cap and a floor) but gives the issuer the option to settle by delivering the maximum (fixed) number of shares. More specifically, link to the discussion on whether the issuer's early settlement

option is substantive. “To determine whether the early settlement option is substantive, the issuer will need to understand whether there are actual economic or business reasons that the issuer would exercise the option. For example, among other factors, the issuer could consider whether the instrument would have been priced differently if the issuer’s early settlement option had not been included in the contractual terms”.

The effects of laws on contractual terms:

- (a) welcomed the IASB’s discussions on the interaction between the terms and conditions of a contract and applicable law to avoid a blanket rejection of the effects of the law from classification and to discuss with regulators the challenges that arise with imposed regulation. Nonetheless, it was considered that the IASB should make clear that applicable law also encompasses financial regulation;
- (b) considered that Mandatory Tender Offers (MTO) were an important issue that needed to be addressed in the future;
- (c) one member was not convinced that the IASB’s tentative decision would be sufficient to address the issues that arise with the interaction between some contingent financial instruments and the bank recovery and resolution directive (BRRD). This is because the BRRD overrides all other legislation and contractual terms. Therefore, the IASB will need to clarify that the proposed clarifications will only apply on a going concern basis;
- (d) noted that it may be difficult to assess whether the terms explicitly stated in the contract are actually in addition to what is established by law (i.e., an entity would have to consider all elements of the law to assess whether the rights and obligations are in addition to those). Therefore, disclosures may be needed to explain the interaction between the contractual terms and applicable law (e.g., when applicable laws prevent the enforceability of a contractual right or a contractual obligation or when specific obligations arise from applicable laws such as BRRD or an MTO).

Shareholders discretion

- (a) noted the difficulty and subjectivity of developing guidance on how to determine whether the shareholders are acting in their individual capacity or as part of the entity’s operating and corporate governance processes;
- (b) the IASB’s factors-based approach may have a high impact on current requirements and change significantly current practice. If the new factors lead to the conclusion that the decision of shareholders is not within the control of the entity, this would lead to the reclassification of some instruments (from equity to financial liabilities), having a significant impact on current practice;
- (c) it is important to test the approach to avoid any unintended consequences, including situations where there are institutional investors (e.g., funds).

Obligations to redeem own equity instruments

- (d) EFRAG FIWG members agreed that the IASB should at least refer and include a question in a forthcoming ED on the issue related to subsequent measurement changes to the redemption amounts as per IAS 32.23, in particular in relation to written put options and forwards contracts on non-controlling interests (NCI puts). This is because there are different views in practice on whether such measurement changes should be recognised in profit or loss or in equity.
- (e) EFRAG FIWG members considered that it was counter-intuitive to have a redemption amount recognised as a liability (reflecting a claim from NCI) and

at the same time have the related NCI recognised within equity (the contra to the liability would be a general reduction in equity and not reduction in NCI). However, members recognised that it was important to have clear requirements in this area to improve comparability and eliminate diversity in practice that continues to exist.

- (f) EFRAG FIWG members considered that it was important to provide relevant additional information to users on own equity transactions, which could be provided through more disaggregation of the face of the financial statements or in the notes.

EFRAG FR Technical Expert Group

10 EFRAG FR TEG has been receiving updates on the project and provided the following feedback (November 2021, May 2022 and November 2022):

- (a) welcomed the IASB's tentative decision to address issues that arise in practice by clarifying some underlying principles in IAS 32 and adding application guidance to facilitate consistent application of the principles.
- (b) welcomed the list of issues that the IASB would consider in this project and the project timeline.
- (c) On the fixed-for-fixed condition for financial instruments settled in own equity instruments, EFRAG FR TEG members considered that further research was needed for preservation and passage of time adjustments.
- (d) questioned whether the IASB was going to retain the 'foreign currency rights issue' exception as it was considered useful.
- (e) highlighted the importance of having enhanced disclosures on financial instruments with characteristics of equity.
- (f) In general, EFRAG FR TEG-CFSS welcomed improvements to disclosures on the priority of claims on liquidation, potential dilution and information about terms and conditions.
- (g) On disclosures about priority on liquidation, EFRAG FR TEG-CFSS members highlighted that the interaction between the contractual terms and the law (e.g., bail-in instruments) raised many challenges. Thus, members welcomed the IASB efforts to address these challenges with improvements to disclosures. In addition, if short-term liabilities were in the scope of such disclosures, then the IASB should also consider interim financial statements.
- (h) On disclosures about potential dilution, EFRAG FR TEG-CFSS members highlighted the importance of having additional information for both listed and non-listed entities and having a better definition of dilution.
- (i) EFRAG FR TEG-CFSS members highlighted the risk of disclosure overload and suggested that the IASB focus on the most relevant and material financial instruments (e.g. those with characteristics of equity and debt) and allow cross references to existing regulatory information.
- (j) welcomed the IASB's tentative decision to clarify the accounting for compound financial instruments with contingent settlement provisions and noted that the clarifications seemed to be fairly aligned with current practice and current requirements in IAS 32 (e.g. paragraph BC12 of the Basis for Conclusions of IAS 32 which refers to the treatment of financial instruments with contingent settlement provisions as financial liabilities for the full amount of the conditional obligation). However, members noted that in practice there are entities that are recognising discretionary distributions in profit or loss. Thus, they are allowed to apply hedging accounting to such instruments. If

discretionary distributions have to be presented in equity, this will represent a change to some entities.

- (k) on the meaning of liquidation, considering that different jurisdictions have different requirements for the liquidation process, the IASB should clearly explain the meaning of 'process of permanently ceasing operations. This is because, the meaning of liquidation for accounting may end up being different from the meaning of legal liquidation.
- (l) some members considered that the threshold for being considered non-genuine should be high.
- (m) On the meaning of non-genuine and liquidation, it would be useful to consider how these concepts are used in other IFRS Standards, as a change to their definition in this project may have knock-on effects on other IFRS Standards.
- (n) Considered that the IASB should further discuss the effects of laws on contractual terms and better explain its principles on when the law should be considered for classification purposes. In addition, the IASB should test its approach against some well-know financial instruments, such as bail-in instruments and instruments that involve mandatory distribution of dividends by law or by contractual terms.
- (o) highlighted the importance of addressing the issues that arise in practice with the accounting for mandatory tender offers;
- (p) On shareholders discretion, members highlighted how difficult and subjective it is to develop guidance on determining whether the shareholders are acting in their individual capacity or as part of the entity's operating and corporate governance processes. Thus, field testing on the final wording would be needed. Members also suggested having a rebuttable presumption on shareholders discretion.
- (q) welcomed the IASB's discussions on 'obligations to redeem own equity instruments' as this is a topic where companies use many different accounting policies when accounting for such obligations.
- (r) On initial recognition of 'obligations to redeem own equity instruments', a few members considered that it was counter-intuitive to a have a redemption amount recognised as a liability (reflecting a claim from NCI) and at the same time have the related NCI recognised within equity (the contra to the liability would be a general reduction in equity and not reduction in NCI).
- (s) On subsequent measurement of 'obligations to redeem own equity instruments', members considered that the IASB should at least refer and/or include a question in a forthcoming exposure draft on the issue related to subsequent measurement changes to the redemption amounts. This is because there were members and stakeholders who disagreed with having such measurement changes being recognised in profit or loss (e.g., it will be difficult for management to explain the entity's performance if such instruments impact profit or loss).
- (t) On the recognition of a liability for the present value of the option exercise price, a few members considered that it was debatable whether a parent recognises a financial liability for the present value of the option exercise price (on a gross basis) or a derivative liability (on a net basis at fair value).
- (u) On options with caps, a few members did not agree that the financial liability should be measured at the capped amount, particularly if the fair value of the liability is smaller than the capped amount. Thus, this issue should also be discussed in the forthcoming ED.

- (v) A few members considered that the IASB should clarify the accounting for NCI puts in separate financial statements, including initial measurement.
 - (w) Members in general considered that the impact of the forthcoming ED would depend significantly on the wording used by the IASB and highlighted the importance of improved disclosures.
- 11 In April 2022 the EFRAG FR TEG and EFRAG User Panel members received an update on the IASB's redeliberations and provided the following feedback
- (a) welcomed the IASB's refinements to the disclosures proposed in the 2018 Discussion Paper. In particular, members welcomed having more disclosures on potential maximum dilution of ordinary shares and suggested having a scenario approach for these disclosures.
 - (b) although EFRAG User Panel members were not usually focused on liquidation in their analysis, information about the priority on liquidation would be particularly useful if it showed the capital and funding structure of the group.
 - (c) on compound financial instrument with contingent settlement features, in practice there are entities that are recognising discretionary distributions in profit or loss. Consequently, they are allowed to apply hedging accounting on such instruments. If these discretionary distributions have to be presented in equity, these would represent a change to some entities.
- 12 In June 2022, the EFRAG FR TEG and EFRAG CFSS members discussed some of the IASB's tentative decisions to date, in particular financial instruments with contingent settlement provisions and effects of laws on the contractual terms.
- (a) Members in general supported the direction of the IASB discussions on compound instruments with contingent settlement provisions. However, some members noted that in practice there are entities recognising discretionary distributions in profit or loss. Thus, such entities are allowed to apply hedging accounting to such instruments. If discretionary distributions have to be presented in equity, this will represent a significant change to some entities.
 - (b) On the meaning of liquidation, members highlighted the risk that the meaning of liquidation for accounting purposes may end up being different from the meaning of legal liquidation; and
 - (c) Finally, on the effect of laws on contractual terms, members considered that the IASB should further discuss and better explain its principles on when the law should be considered for classification purposes.

EFRAG FR Board

- 13 In July 2022 the EFRAG FRB members received an update on the IASB's redeliberations and provided the following feedback:
- (a) Members agreed with the general direction of the project. This project is particularly relevant for financial institutions that typically issue complex financial instruments. If the clarifications will result in changes in classification, this may lead to implementation costs.
 - (b) Members considered that the wording would be key for the forthcoming Exposure Draft. Members suggested that the EFRAG Secretariat proceeds with an analysis for different financial instruments, comparing the outcome of the IASB clarifications with what we have today in IAS 32 to better assess the impact of the IASB clarifications.

Agenda Papers

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

FICE – Cover Note

- (a) Agenda paper 07-02 – Presentation of equity and financial liabilities; and
- (b) Agenda paper 07-03 – Sweep Issues