

This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG TEG-CFSS. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG-CFSS. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

## **Financial Instruments with Characteristics of Equity Cover Note**

### **Objective**

- 1 The objective of the session is to seek feedback from EFRAG TEG-CFSS members on potential refinements to the disclosures proposed in the 2018 Discussion Paper *Financial Instruments with Characteristics of Equity*.
- 2 In addition to this cover note, agenda paper 06-02 – *ASAF 03 Paper on FICE disclosures* – has been provided for the session.
- 3 Finally, in Appendix 1 of this agenda paper, you may find a summary of the IASB's discussions and tentative decisions until now.

### **IASB Outreach activities on Disclosures**

- 4 In 2020, the IASB staff undertook a number of outreach activities on potential disclosures that can be developed as part of the FICE project. In those outreach activities, the IASB Staff presented potential refinements for each type of disclosure to address some of the concerns and suggestions raised by respondents to the 2018 Discussion Paper *Financial Instruments with Characteristics of Equity* (2018 DP).
- 5 At future meetings, the IASB staff plan to present their recommendations to the IASB, along with their analysis of the feedback received from stakeholders, for decision by the IASB.
- 6 The IASB staff started their outreaches with users of financial statements to make sure that the potential disclosure refinements were useful to them. After having sufficient support from users of financial statements, the IASB staff performed outreaches with other types of stakeholders to further understand, for example, whether there are overlapping regulatory disclosures and the costs for, and efforts of, preparers.

### **Potential refinements to proposals**

- 7 In the outreach activities, the IASB staff discussed potential refinements to:
  - (a) Information about priority on liquidation;
  - (b) Information about potential dilution; and
  - (c) Information about terms and conditions.

#### *Information about priority on liquidation*

- 8 The IASB staff are exploring the following refinements:

## *Financial Instruments with Characteristics of Equity – Cover Note*

- (a) Priority information disclosed by individual entity for the parent and each subsidiary that has issued material financial instruments with a reconciliation to the group consolidated amounts;
- (b) Disclose carrying amounts of financial liabilities and equity instruments in the notes to the financial statements showing the order of priority on liquidation based on contractual terms and qualitative information about contractual terms and conditions that affect the priority;
- (c) If an entity is subject to regulation that specifies a resolution process (eg a bank), either before or instead of, liquidation, provide information about priority on that basis;
- (d) If relevant, disclose the fact that the legal priority of claims on liquidation differs from the priority purely based on the contractual terms. Provide a narrative description, to the extent possible, of the effect of the legal view of priority on liquidation;
- (e) Provide a narrative description, to the extent possible, of the effect of non-financial liabilities and financial instruments which are scoped out of IAS 32 *Financial Instruments - Presentation* on the order of priority on liquidation; and
- (f) Disclose details of any parent-subsidiary guarantee or other intra-group arrangements that might impact priority on liquidation.

### *EFRAG Comment Letter on the 2018 DP*

- 9 In its final comment letter, EFRAG generally welcomed the DP's proposed disclosures about the priority of claims on liquidation, potential dilution and information about terms and conditions. EFRAG considered that improvements to existing disclosures was a key part of this project, not only for the consolidated financial statements of a group but also to the separate financial statements of the entities within a group.
- 10 EFRAG also supported the DP's proposal to improve disclosures on priority of financial liabilities and equity instruments on liquidation. Nonetheless, EFRAG noted that some considerations would have to be taken into account in terms of the reporting entity which is being considered. EFRAG noted that, in most jurisdictions, it is the legal entity that has the capacity to enter into agreements or contracts, assume obligations, incur and pay debts, sue and be sued in its own right, and is ultimately held responsible for its actions. Considering this, EFRAG recommended the IASB to continue to develop proposals to improve disclosures on priority of claims on liquidation both on separate and, if practicable, consolidated financial statements and any interactions between the two.
- 11 Finally, EFRAG considered that such disclosures should reflect the carrying amounts presented in the statement of financial position and not the fair value amounts required by IFRS 7 *Financial Instruments: Disclosures*. This is because fair value measurement would require entities to calculate the fair value of their instruments on own equity and would break the link to the statement of financial position. In addition, EFRAG noted that fair value amounts would be even more onerous for non-listed entities.

### *Feedback received from EFRAG User Panel on 7 July 2020*

- 12 EFRAG User Panel received a presentation from the IASB staff on potential improvements to disclosures on financial instruments with characteristics of equity and provided the following feedback:
  - (a) members noted that the priority of claims are important to assess the quality of capital and some narrative information would be helpful although one commented that it is most important to credit analysts.

- (b) a member also noted that this is obviously from a legal perspective of a business that may end in liquidation.

Feedback received from EFRAG FIWG on 13 November 2020

13 EFRAG FIWG members received a presentation from the IASB staff on potential improvements to disclosures on financial instruments with characteristics of equity and provided the following feedback:

- (a) welcomed the IASB staff proposal that ‘if an entity is subject to regulation that specifies a resolution process (e.g. a bank), either before or instead of, liquidation, the entity provides information about priority on that basis’;
- (b) considered that for banks, it was important to ‘disclose the fact that the legal priority of claims on liquidation differs from the priority purely based on the contractual terms’. In particular, it was considered important to provide information on the legal priority under a resolution/bail-in mechanism. This is because European banks were not required to reflect in their contracts the legislation on bank recovery and resolution, hence disclosure should consider both legal and contractual priority;
- (c) entities that currently have many subsidiaries may find difficult to provide, in their consolidated financial statements, a table showing ‘priority of financial instruments on liquidation of each individual entity based on contractual terms of the instruments’. Thus, it was fundamental to define the right scope for these disclosures (e.g. only subsidiaries that have issued significant financial instruments for funding purposes in the market);
- (d) questioned whether users of financial statements asked information about the underlying assets when analysing waterfall payment structures;
- (e) when providing information about priority on liquidation, it was important to give management some flexibility so that they can provide, according to their views, the most relevant information about company’s priority on liquidation. For that, the IASB would have to provide more general principles around the disclosure requirements and the underlying disclosure objective;
- (f) noted that 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;
- (g) noted that financial institutions were already providing a lot of information related to priority of claims and questioned whether the IASB would allow cross-references to information outside of the financial statements (e.g. website of the company); and
- (h) acknowledged that financial institutions were heavily regulated and had to provide a lot of information about their financial instruments for transparency reasons. However, for non-financial unlisted entities, disclosing the contractual terms of financial instruments may raise confidentiality issues. Considering this, it was important to have one set of disclosure principles that would encompass both ends of the spectrum.

EFRAG Secretariat analysis

14 In general, the EFRAG Secretariat considers that the IASB staff proposals seem to be in line with EFRAG recommendations included in its Comment Letter on the 2018 DP. The EFRAG Secretariat also notes that both the EFRAG User Panel and EFRAG FIWG members welcomed the IASB staff proposals. Therefore, the EFRAG Secretariat welcomes the IASB’s efforts to improve disclosures about priority on liquidation.

- 15 The EFRAG Secretariat also subscribes to all the comments provided by the EFRAG User Panel and EFRAG FIWG members on the IASB staff proposals.
- 16 EFRAG Secretariat only notes that the proposed disclosures should be subject, as usual, to materiality considerations, particularly for entities with multiple subsidiaries. In addition, considering the complexity of the information provided, it is key that the IASB clearly identifies the scope and the principles behind the proposed disclosures to avoid disclosure overload and boilerplate information.
- 17 In addition, the EFRAG Secretariat notes that the use of the wording ‘on liquidation’ raises a number of challenges, which were identified in EFRAG’s Comment Letter. More specifically, entities prepare financial statements on a going concern basis and real-life situations can be more complex than simply liquidation. For example, if an entity fails to satisfy debt holders’ claims, debt holders may prefer to take control of the entity for restructuring rather than enter into liquidation. Similarly, for regulated financial entities, the issue can be more related to a ‘resolution’ than to ‘liquidation’ and this would bring complexity to the distinction between debt and equity, as many instruments would be, on the trigger event for resolution, converted into shares or even written down before actual liquidation.
- 18 Thus, the EFRAG Secretariat questions whether the disclosures should focus on ‘company’s capital structure’ (i.e. different levels of seniority and subordination), rather than on ‘liquidation’. IFRS Standards currently include some disclosure requirements about a company’s capital structure. The IASB staff’s proposed disclosures could be developed within that framework and provided in a single note (currently disclosures about a company’s capital structure are often spread across management commentary and the notes to financial statements). The EFRAG Secretariat believes that this could be the most efficient and effective way for investors and lenders to obtain a comprehensive picture of the rights and obligations created by a company’s liability and equity claims.
- 19 Finally, the EFRAG Secretariat considers that such information could also be provided together with a comparative to previous year.

**Questions for EFRAG TEG-CFSS**

- 20 Do you have any comments about the potential disclosure refinements for information about priority on liquidation?
- 21 In particular:
  - If the order of priority on liquidation is based purely on the contractual terms of financial liabilities and equity instruments, what are your views on disclosing the following narrative information as a simplification:
    - how legal priority on liquidation differs from contractual priority; and
    - how non-financial and other liabilities eg tax liabilities and employee benefits may impact the order of priority on liquidation?
  - Because carrying amounts may differ from liquidation recoverable amounts or fair values
    - should quantitative information be provided at all; and
    - if so, should the measurement basis be specified?

*Information about potential dilution*

- 22 The IASB staff are exploring the following refinements to existing information about potential dilution for both listed and unlisted entities, which would have to:

- (a) disclose the maximum number of additional ordinary shares that could be issued for each type of potential ordinary shares outstanding at the reporting date (instead of a reconciliation of changes during the reporting period);
- (b) provide a narrative explanation of any significant changes in the maximum number;
- (c) provide a narrative description of the instruments accounted for under IFRS 2 *Share-based Payment*, eg employee share options. Relevant IFRS 2 information could be cross referenced.
- (d) provide information about the key terms and conditions relevant to understanding potential dilution such as strike price, exercise date and any conditions for exercise.

*EFRAG Comment Letter on the 2018 DP*

- 23 In its comment letter ([here](#)), EFRAG supported the proposal in the DP to improve disclosures on dilution, particularly disclosures around the total number of ordinary shares outstanding or potentially outstanding at the end of the period and their effects.
- 24 However, EFRAG noted that currently IAS 33 *Earnings per Share* applies only to entities whose ordinary shares or potential shares are publicly traded. Considering this, EFRAG recommended that the IASB further considers the scope of such disclosures. That is, whether such disclosures would only apply to listed entities and whether they should apply to both separate and consolidated financial statements.
- 25 Finally, EFRAG noted that in its comment letter to the IASB Discussion Paper *Conceptual Framework for Financial Reporting*, EFRAG identified potential ways to disclose dilutive effects: (a) scenario analysis, depicting the instruments in issue and their rights and/or payoffs in various material scenarios; and/or (b) the provision by the entity of financial models showing the rights holders of various instruments have on net cash inflows, and how the number and types of these instruments may change.

*Feedback received from EFRAG User Panel on 7 July 2020*

- 26 EFRAG User Panel received a presentation from the IASB staff on potential improvements to disclosures on to existing information about potential dilution and provided the following feedback:
  - (a) Members agreed that the number of fully diluted shares are important and that better disclosures on the potential shares for a detailed understanding would be an improvement. Analysts may apply judgement and may not do the calculation in the same way as the applicable standard and so more information is important. For example, stock options that were currently out of the money would not be dilutive per IAS 33, but depending on the maturity of the options, it may be reasonable to take these into consideration.
  - (b) Another member emphasised the need for information on current out-of-the-money potential share issues as these may become relevant over time.
  - (c) Another member thought the proposed disclosures are good but pointed out that the information was more important for unlisted entities, as some have very complicated capital structures with many participating instruments. Therefore, the disclosure about the terms was critical including information about target values and the implications of these for dilutive impact. This could be very important where sale of a business may mean that instruments share differently in such a price.

Feedback received from EFRAG FIWG on 13 November 2020

- 27 EFRAG FIWG members received a presentation from the IASB staff on potential improvements to disclosures on to existing information about potential dilution and provided the following feedback:
- (a) there were questions on the interaction between IFRS 2 and IAS 32, in particular whether disclosures on potential dilution would be different depending whether the financial instruments were within the scope of IFRS 2 or IAS 32;
  - (b) suggested that the IASB clarifies the articulation of the proposed disclosures with the disclosures that already exist under IAS 33; in particular the differences and similarities between them to mitigate the risk of duplication and disclosure overload;
  - (c) raised questions on whether the disclosures were required for the 'reporting entities' that are listed and unlisted. For unlisted entities, not all disclosure requirements may be applicable, e.g. in the absence of a share price. That is, whether they applied to separate and consolidated financial statements of the listed and unlisted entities; and
  - (d) considered that the IASB may need to require qualitative disclosures on financial instruments for a fixed amount that are settled with a variable number of shares (which in theory can result in 'infinite' dilution).

EFRAG Secretariat analysis

- 28 In general, the EFRAG Secretariat considers that the IASB staff proposals seem to be in line with EFRAG recommendations included in its Comment Letter on the 2018 DP. The EFRAG Secretariat also notes that both the EFRAG User Panel and EFRAG FIWG members welcomed the IASB staff proposals. Therefore, the EFRAG Secretariat welcomes the IASB staff's efforts to improve and simplify the disclosures on potential dilution.
- 29 The EFRAG Secretariat also subscribes to all the comments provided by the EFRAG User Panel and EFRAG FIWG members on the IASB staff proposals. In particular, the EFRAG welcomes the simplicity of the information provided when compared to existing IAS 33 requirements. Nonetheless, the EFRAG Secretariat highlights the importance of highlighting the differences and similarities between the existing requirements in IAS 33 and the IASB's staff proposed requirements.

**Questions for EFRAG TEG-CFSS**

- 30 Do you have any comments about the proposed disclosure refinements for potential dilution?
- 31 In particular:
- What do you think about the potential simplification of including a narrative description of equity-settled share-based payments with cross reference to IFRS 2 disclosures (i.e. excluded from calculation of maximum number of additional shares)?
  - Should the disclosures be provided by both listed and unlisted entities?

*Information about terms and conditions*

- 32 The IASB staff are exploring the following refinements to disclosures about terms and conditions, which would be presented in a single note to the financial statements:

- (a) For all capital instruments issued for longer-term funding, the key terms and conditions that affect the nature, timing, amount and uncertainty of future cash flows. For example: conditions that trigger early redemption or refinancing in cash or conversion into ordinary shares, step-up clauses, terms that allow an entity to defer the payment of interest and information about covenants associated with outstanding claims.
  - (b) For instruments where classification involves significant judgement because instruments have characteristics of both equity and debt, disclose the key features (including assumptions and judgements) that led to the classification.
  - (c) Disclose information about any voting rights. If the voting right is only exercisable in specified circumstances, describe those circumstances.
- 33 Such information can be provided in a tabular format as a table of key terms with one line per type of instrument.

*EFRAG Comment Letter on the 2018 DP*

- 34 In its Comment Letter, EFRAG considered that the IASB should give high priority to additional disclosures on the terms and conditions of financial instruments with characteristics of equity. In particular, EFRAG noted that for financial instruments that have many features, it is often difficult to understand what the key features are that lead to the classification of equity or liability (e.g. bail-in instruments).
- 35 Some points to consider were noted as:
- (a) how to disclose the information about write downs;
  - (b) key features that lead to the classification as equity or liability and how judgement has been applied;
  - (c) information about early redemptions and incentives to pay; and
  - (d) equity and liability characteristics within an instrument, regardless the classification, and related risks.

*Feedback received from EFRAG User Panel on 7 July 2020*

- 36 EFRAG User Panel received a presentation from the IASB staff on potential improvements to disclosures on terms and conditions of financial instruments with characteristics of equity.
- 37 Members generally approved of the proposed approach as there was often a lack of information for entities in crisis around debt and timing of payments. It was acknowledged that for some large financial institutions there would be a lot of information involved but this could be summarised as the simplified example demonstrated the importance of obtaining the right disclosures

*Feedback received from EFRAG FIWG on 13 November 2020*

- 38 EFRAG FIWG members received a presentation from the IASB staff on potential improvements to disclosures on terms and conditions of financial instruments with characteristics of equity and provided the following feedback:
- (a) noted that financial institutions are already required to provide tabular information on the key terms and conditions of capital instruments to regulators (EBA). Thus, they suggested that the IASB provides some flexibility to financial institutions so that they can recycle and use similar information under IFRS Standards (to avoid duplication);
  - (b) appreciated disclosures on significant judgement exercised when classifying financial instruments; such disclosures have already proven helpful under other standards (e.g. IFRS 10 *Consolidated Financial Statements*);

- (c) suggested that the IASB clearly limits the scope of such disclosures to avoid disclosure overload (avoid having disclosures on all financial instruments issued by a reporting entity and instead focus on instruments that are used for long-term funding purposes); and
- (d) highlighted the importance of having some form of field-testing of the IASB proposals.

*EFRAG Secretariat analysis*

- 39 In general, the EFRAG Secretariat considers that the IASB Staff proposals seem to be in line with EFRAG recommendations included in its Comment Letter on the 2018 DP. The EFRAG Secretariat also notes that both the EFRAG User Panel and EFRAG FIWG members welcomed the IASB staff proposals.
- 40 The EFRAG Secretariat subscribes to all the comments provided by the EFRAG User Panel and EFRAG FIWG members on the IASB staff proposals. In particular, the EFRAG Secretariat would like to highlight the importance of having field-testing before the issuance of a new IFRS Standard.
- 41 Finally, the EFRAG Secretariat highlights the importance of providing information about early redemptions and incentives to pay, particularly for instruments with contingent settlement features (as mentioned in EFRAG's Comment Letter).

**Questions for EFRAG TEG-CFSS**

- 42 Do you have any comments about the potential disclosure refinements for terms and conditions?
- 43 In particular:
  - do you think the scope of these disclosures should be limited only to instruments where classification involves significant judgement because instruments have characteristics of both equity and debt?

## Appendix 1: IASB discussions and tentative decisions until now

- 44 On March 2019 the IASB started to consider the feedback received on the different sections of the IASB's *Discussion Paper Financial Instruments with characteristics of Equity* (DP).
- 45 In September 2019, the IASB discussed the direction of the FICE project and tentatively decided on an approach that addresses practice issues by clarifying some principles in IAS 32 (aligned with the EFRAG position stated in its comment letter ([here](#)))
- 46 In October 2019, the IASB discussed the overall objectives of the project, the issues that arise in practice which could be address within the project, and the project timetable for indicative commencements of deliberations on each issue. The IASB staff identified the following list of issues that could be addressed within the project on making clarifying amendments to IAS 32:
- (a) classification of financial instruments that will or may be settled in the issuer's own equity instruments, e.g. application of the fixed-for-fixed condition to particular derivatives on own equity and the classification of mandatorily convertible financial instruments;
  - (b) accounting for obligations to redeem own equity instruments, e.g. accounting for written put options on non-controlling interests (NCI puts);
  - (c) accounting for financial instruments that contain contingent settlement provisions, e.g. financial instruments with a non-viability clause;
  - (d) the effect of laws and regulations on the classification of financial instruments;
  - (e) reclassification between financial liability and equity instruments, e.g. when circumstances change, or contractual terms are modified; and
  - (f) classification of particular financial instruments that contain obligations that arise only on liquidation of the entity, e.g. perpetual financial instruments.
- 47 In December 2019 and April 2020 the IASB discussed potential clarifications to IAS 32 that would help address challenges in practice in classifying financial instruments that will or may be settled in the issuer's own equity instruments. In particular, the IASB explored potential clarifications to the underlying principle for classifying derivatives on own equity (fixed-for-fixed criterion).

### *Financial instruments settled in an entity's own equity instruments: foundation principle*

- 48 The IASB 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:
- (a) allowable preservation adjustments; or
  - (b) allowable passage of time adjustments.
- 49 The IASB also 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.

### *Financial instruments settled in an entity's own equity instruments: adjustment principle*

- 50 The IASB tentatively decided that an entity would be required to classify derivatives on own equity as equity instruments if preservation adjustments require the entity to preserve the relative economic interests of future shareholders to an equal or a lesser extent than those of the existing shareholders. This proposal was presented as Alternative B in the Agenda Paper.

- 51 The IASB also tentatively decided that an entity would be required to classify derivatives on own equity as equity instruments if passage of time adjustments:
- (a) are pre-determined and vary only with the passage of time; and
  - (b) fix the number of functional currency units per underlying equity instrument in terms of a present value.