EFRAG Board MEETING
Agenda paper 06-02
FICE TEAM

UPDATE ON FICE

EFRAG BOARD 6 JULY 2022

FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF EQUITY (FICE)

EFRAG

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THE EFFECTS OF LAW ON CONTRACTUAL TERMS

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BACKGROUND

2018 IASB DISCUSSION PAPER

- The 2018 IASB DP *Financial Instruments with Characteristics of Equity* focused on potential improvements to the classification, presentation and disclosure requirements of financial instruments within the scope of IAS 32 *Financial Instruments: Presentation*
- EFRAG FCL (February 2019)
  - EFRAG did not support the IASB's preferred approach to classification
  - EFRAG acknowledged that some constituents called for a more conceptual approach to distinguish debt from equity, however EFRAG did not identified any consensus on how to achieve such an approach
  - EFRAG suggested that the IASB focuses on targeted improvements to current requirements in IAS 32 and other standards, including supporting guidance in IAS 32
  - EFRAG also suggested that the IASB pursues improvements to disclosures
- For more details, please see EFRAG Website and EFRAG Feedback statement

OBJECTIVE AND TIMELINE

NEW OBJECTIVE OF THE PROJECT

- improve information provided in financial statements about financial instruments issued
- address known practice issues applying IAS 32 without fundamentally rewriting IAS 32

Q4 2019	Q2 2020	Q1 2021	Q2 2021	Q3 2021 to date		TBD
Project plan agreed	Fixed-for-fixed condition discussion concluded	‘Perpetual instruments’ discussion started	Disclosures discussion concluded	Contingent settlement provisions, the effect of law, shareholders discretion and reclassification	…	Exposure Draft

CLARIFYING THE FIXED FOR FIXED CONDITION

- Questions arise in practice on the **meaning of 'fixed-for-fixed** and whether there are types of variability that do not violate the fixed-for-fixed condition (e.g., anti-dilutive features or passage of time cash adjustments)
- The IASB proposes **two principles to meet 'fixed-for-fixed' condition** in paragraph 16(b)(ii) of IAS 32.

Foundation principle - fixed-for-fixed condition for derivatives on own equity

The number of functional currency units to be exchanged with each share is fixed

Adjustment principle – these adjustments would not preclude equity classification

Preservation adjustments preserve relative economic interests of future shareholders to an equal or a lesser extent than those of existing shareholders

Passage-of-time adjustments:

- are pre-determined
- vary only with passage of time
- fix the amount per share in terms of present value

Discussions at EFRAG

What about the foreign currency rights issue' exception?

Support for the new principles that capture current practice, even if it may lead to some changes

The wording for the passage-of-time adjustments is key

DISCLOSURES

KEY TERMS AND CONDITIONS

Objective

- Help investors better understand the nature, amount, timing and uncertainty of cash flows arising from issued financial instruments

Scope

- Financial instruments with characteristics of both debt and equity
- Includes compound instruments
- Excludes standalone derivatives

Disclosure requirements

Highlight in the disclosures:

- The cash flow characteristics that are not 'typical' of the instrument's classification (eg fixed or determinable amounts of cash flows at fixed dates are 'typical' cash flows of debt instruments but not equity instruments)
- The key features that determine classification

Discussions at EFRAG

key to define debt-like features or equity-like features

Support for disclosures on key features that determine classification as often difficult to understand what was key.

Not sufficient to only provide contractual terms but should also consider effects of law on the contractual terms.

DISCLOSURES – MAXIMUM DILUTION OF ORDINARY SHARES

MAXIMUM DILUTION OF ORDINARY SHARES

Objective

- Provide information about dilution that could arise from any potential increase in number of issued ordinary shares
- Not to replace Diluted EPS calculation

Scope

- All instruments and transactions settled by delivering ordinary shares
- Includes IFRS 2 instruments and transactions (entities can leverage existing IFRS 2 disclosures)

Disclosure requirements

- The underlying principle is for an entity to assume:
  - maximum possible increase in number of shares for instruments that could be settled by delivering own shares
  - minimum reduction in number of shares for instruments to repurchase own shares
- Disclosures include key terms and conditions relevant to understanding the likelihood of maximum dilution and the possibility for unknown dilution

Discussions at EFRAG

Risk of disclosure overload - focus on the most relevant and material financial instruments

It is important to have a better definition of dilution

Important to link with the concept of resolution as some instruments may be mandatorily converted into equity

Have a more scenario driven approach

DISCLOSURES – PRIORITY ON LIQUIDATION

CLAIMS AGAINST THE ENTITY

Objective

Provide information about nature and priority of claims against the entity that arise from financial instruments

Scope

All financial liabilities and equity instruments within the scope of IAS 32

Disclosure requirements

Categorise financial instruments by differences in nature and priority, distinguishing between:

- secured and unsecured
- contractually subordinated and unsubordinated
- issued/owed by parent and issued/owed by subsidiaries

Discussions at EFRAG

If short-term liabilities are in the scope of these disclosures, then the IASB should also consider interim financial statements

Wording 'liquidation' raises many challenges, eg, impact of resolution, otherwise financial statements will not reflect the complexity of a financial institution

Useful to show the capital and funding structure of the group

Challenges determining whether priority stems from the contract or from related law/regulation

DISCLOSURES – PRIORITY ON LIQUIDATION

CONTRACTUAL TERMS ABOUT PRIORITY

Objective

Provide information about the risks and returns of financial instruments on liquidation of the entity

Scope

- Financial instruments with characteristics of both debt and equity
- Includes compound instruments
- Excludes standalone derivatives

Requirements

Disclose terms and conditions about priority of financial instruments on liquidation, including:

- terms that indicate priority
- terms that could lead to changes in priority
- details of intragroup arrangements such as guarantees

Discussions at EFRAG

Key to define debt-like features or equity-like features

Allow cross references to existing regulatory information

Areas of complexity that should be considered such as the legal structure of international groups

CONTINGENT SETTLEMENT PROVISIONS

CLARIFYING GUIDANCE IN IAS 32 FOR SPECIFIC INSTRUMENTS

- 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 (e.g., bail-in instruments, which are instruments mandatorily convertible into shares upon a contingent 'non-viability' event)

Clarifications to be included in IAS 32 for instruments with contingent settlement provisions

- financial instruments with contingent settlement provisions may be compound instruments
- 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 obligation
- 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

- Such guidance would clarify, for example, the accounting for some instruments discussed by the IFRS Interpretations Committee. For example, financial instruments that are mandatorily convertible into a variable number of shares upon a contingent 'non-viability (bail-in instruments) would be a **compound instrument** with a liability component (full amount) and an equity component. All interest payments recognised in equity.

CONTINGENT SETTLEMENT PROVISIONS

CLARIFYING WORDING IN IAS 32

- Questions arise in practice on how to interpret the **meaning of 'liquidation**' in paragraph 25(b) of IAS 32 in the context of processes that are similar to liquidation (e.g. resolution or restructuring)
- Questions arise in practice on how to interpret the **meaning of 'non-genuine'** in paragraph 25(a) of IAS 32 (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)

Clarifications to be included in IAS 32

- 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
- 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

- This guidance is likely to address some of the concerns that arise in practice, particularly with bail-in instruments (e.g. how non-genuine and liquidation interact with the bank recovery and resolution legislation

THE EFFECTS OF LAWS ON CONTRACTUAL TERMS

WHAT IS THE MEANING OF 'CONTRACTUAL'?

- The 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
- This is particularly relevant for instruments such as bail-in instruments, ordinary shares with statutory minimum dividends and mandatory tender offers (e.g. whether the laws in a particular jurisdiction that affect the rights and obligations established in a contract should be considered part of or even reproduced in the contractual terms)

Clarifications to be included in IAS 32

An entity would be required to classify financial instruments as financial liabilities or equity by considering:

- 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
- applicable laws that prevent the enforceability of a contractual right or a contractual obligation

- This guidance is likely to address some of the concerns that arise in practice, particularly with bail-in legislation. However, this is not likely to address the issue of Mandatory Tender Offers.

SHAREHOLDERS DISCRETION

- Questions arise in practice on whether an entity has an unconditional right to avoid delivering cash if the contractual obligation is at the ultimate discretion of the issuer's shareholders (e.g. preference shares that include a contractual obligation to deliver cash when the payment is at the discretion of the shareholders)

- More specifically, whether the shareholder decisions are part of the entity's operating and corporate governance processes (thus it has unconditional right to avoid payment of cash) or acting in their individual capacity (thus it does not have the unconditional right to avoid payment of cash)

Clarifications to be included in IAS 32

- The IASB will explore a factors-based approach to help an entity apply its judgement when classifying these types of financial instruments as financial liabilities or as equity. Such an approach would provide examples of potential factors for an entity to consider when assessing whether a decision of shareholders is treated as a decision of the entity.
- This assessment is needed to determine whether an entity has an unconditional right to avoid delivering cash (or settling a financial instrument in such a way that it would be a financial liability).

- There are mixed views on this issue and notes the difficulty and subjectivity of developing guidance on how to determine when the shareholders are acting in their individual capacity. If the IASB decides to proceed, it should be cautious at it may have a high impact on current requirements and practice (lead to less equity).

RECLASSIFICATION

- Currently, IAS 32 has no general requirements on reclassification between financial liabilities and equity instruments. Questions arise in practice on whether IAS 32 permits or requires reclassification after initial recognition where there has been no modification to the contract.
- IASB Staff indicated that practice has developed over time with some diversity as some firms permit reclassification.

Clarifications to be included in IAS 32

- prohibit reclassification other than for changes in the substance of the contractual terms arising from changes in circumstances outside the contract. This does not affect reclassifications already required by IAS 32.
- clarify that when the substance of the contractual terms changes due to changes in circumstances outside the contract, a financial liability reclassified from equity would be measured at fair value at the date of reclassification. Any difference between the carrying amount and the fair value would be recognised in equity.
- In addition, an equity instrument reclassified from a financial liability would be measured at the carrying value of the financial liability at the date of reclassification. No gain or loss would be recognised.
- Finally, a reclassification would be accounted for in the reporting period in which the change in circumstances occurred.

QUESTIONS TO MEMBERS

Q1 – Do EFRAG Board members have any comments on the IASB proposals to improve fixed-for-fixed condition?

Q2 – Do EFRAG Board members consider that the improvements to the disclosures in the DP provide relevant information? Do you expect any implementation difficulties?

Q3 – Do EFRAG Board members consider that the clarifications on contingent settlement provisions, effects of law on contractual terms and shareholders discretion are relevant?

Q4 - Do EFRAG Board members have any comments on the IASB proposals on reclassifications?

Q5 – Any recommendations in terms of topics for the IASB future discussions?

APPENDIX – EXAMPLE ON TERMS AND CONDITIONS

Company X has perpetual subordinated notes that are classified as equity instruments

Note 16 Perpetual subordinated notes

At 31 December 2020, the total perpetual subordinated notes outstanding amounted to CU3,985 million (less net-of-tax transaction costs) and are included in the Company's equity. The table below includes the key terms of these financial instruments.

	Notional amount	Initial call date	Coupon reset after initial call date	2020 CU million	2019 CU million
5.5% Fixed Rate Subordinated Notes	USD 1,000m	Jan 2025	10.5%	690	714
4.5% Fixed Rate Subordinated Notes	EUR 750m	Mar 2028	market rate	647	658
4% Fixed Rate Subordinated Notes	EUR 2,000m	Oct 2032	market rate	1,724	-
3% Fixed Rate Subordinated Notes	GBP 1,000m	Jan 2027	market rate	925	910
				3,985	2,282

Coupon

These notes bear a fixed rate of coupon until their initial call dates. After the initial call dates, if they are not redeemed, the coupon on the notes reset. The coupon on the USD subordinated notes reset to 10.5%. The coupon on the other notes are fixed periodically in advance for five-year periods, based on prevailing market interest rates plus credit spreads of Company X, fixed at issuance.

Company X has discretion to defer coupons on these notes. The deferred coupons accumulate and become payable at the call date if the notes are called, or when Company X is liquidated, if the notes are not called.

Company X is prevented from paying dividends or other distributions in respect of its ordinary shares, or from repurchasing its ordinary shares, until the cumulative coupons on the perpetual subordinated notes have been paid in full.

Redemption option

These notes are redeemable at the option of Company X at the initial call date or any fifth anniversary after this date. The amount redeemable will be the notional amount plus accumulated coupons.

Classification

These notes are classified as equity instruments because Company X has the unconditional contractual right to defer coupons and principal repayments until liquidation of Company X.

Priority on liquidation

[Information about priority of the notes on liquidation of Company X (see Agenda Paper 5B for this meeting.)]

Source: April 2021 IASB paper 5A

APPENDIX – EXAMPLE ON POTENTIAL DILUTION

Instruments	*Maximum number of additional ordinary shares to be disclosed*	*Key terms and conditions relating to the instrument/transaction*
Convertible bonds B	250	In the event of a change of control of Company X prior to the conversion date, the conversion ratio is adjusted downwards to a pre-determined strike price.
Convertible bonds D	350	Issuer holds an option to settle in shares or cash (equal to the value of the shares).
Convertible bonds (A and C)	600	Holder holds an option to convert the bond at a specified conversion date using a specified conversion ratio.
Contingently convertible bond E	50	Conversion contingent on the occurrence of non-viability event X. Redeemable at the option of the issuer for cash.
Share-settled bond F	50 Or unknown dilution (if unlisted shares)	Depending on the share price at settlement date a higher number of shares might need to be delivered.
Mandatorily convertible note G	100	Subject to a cap of 100 shares and a floor of 10 shares.
Number of share options in the scope of IFRS 2 outstanding at reporting date	100	Refer to note x (IFRS 2 disclosures on share options).
Number of known unvested shares from share awards in the scope of IFRS 2 at reporting date	100	Refer to note y (IFRS 2 disclosures on share awards).
Maximum number of additional ordinary shares	**1,600**	

Less: minimum reduction in the number of ordinary shares		
Share buy-back	(100)	Commitment to buy 100 –500 shares.
Net maximum number of additional ordinary shares	**1,500**	

Source: April 2021 IASB paper 5C

APPENDIX – EXAMPLE ON PRIORITY ON LIQUIDATION

Note 12 Nature and priority of claims arising from financial instruments

	As of 31 Dec 2020 (CU million)		
		Issued/owed by	
	Consolidated	parent	subsidiaries
Secured and unsubordinated			
Senior secured debt (a)	1,200	-	1,200
Lease liabilities (a)	920	780	140
Unsecured and unsubordinated			
Trade and other payables	1,450	320	1,130
Senior unsecured debt (a)	450	-	450
Unsecured and subordinated			
Subordinated liabilities (see note 15)	590	480	110
Classified as financial liabilities	*4,610*	*1,580*	*3,030*
Unsecured and subordinated			
Perpetual notes (see note 18)	200	200	-
Irredeemable preference shares (See note 19)	500	400	100
Non-controlling interest	1,250	-	1,250
Shareholders' equity	8,500	8,500	-
Classified as equity	*10,450*	*9,100*	*1,350*
Total	***15,060***	***10,680***	***4,380***

(a) They are included in the 'Borrowings' line item in the statement of financial position.

Note 15 Subordinated liabilities

	As of 31 Dec 2020 (CU million)	As of 31 Dec 2019 (CU million)
EUR100mil 7.125% subordinated notes due 2025	110	110
GBP250mil 6.75% senior subordinated notes due 2030	230	230
USD225mil 7.20% subordinated notes due 2033	165	-
Other subordinated liabilities each less than CU50 millio	85	85
Total subordinated liabilities	590	425

In the event of the respective issuer's liquidation, any amounts due in respect of the subordinated liabilities rank junior to all present and future unsubordinated claims of the respective issuer and rank senior to the respective issuer's ordinary shares, and if any, preference shares and perpetual notes. Subordinated liabilities listed in the table above do not rank pari passu with one another. Some subordinated liabilities are contractually subordinated to other subordinated liabilities.

[other key terms and conditions as discussed at the April 2021 Board meeting, for example, 'equity-like' features in these liabilities and the features that determine their financial liability classification]

Source: May 2021 IASB paper 5

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THANK YOU

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