Financial Instruments with Characteristics of Equity
Cover Note

Objective

1 The objective of the session is to:

(a) provide an update on the IASB's discussions on its project *Financial Instruments with Characteristics of Equity* (FICE); and

(b) obtain EFRAG FR TEG members views on the IASB's tentative decisions.

Background

2 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.

3 After considering feedback on the 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.

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

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

Analysis of the feedback received on the DP *IASB March – July 2019*	• The IASB discussed the feedback received from stakeholders on the Discussion Paper *Financial Instruments with Characteristics of Equity.*
Project Direction *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. • The IASB discussed whether it should move the FICE project from the research programme to the standard-setting programme and decided to add the FICE project to its standard-setting programme. • It also decided to continue using the expertise of advisory bodies instead of establishing a dedicated consultative group for the project.
Project Plan *IASB October 2019*	• The IASB discussed the project plan for the FICE project, including a list of practice issues that could be addressed as part of the project. No decisions were taken.

Classification: financial instruments settled in own equity instruments: fixed for fixed *IASB December 2019 – April 2020*	• The IASB explored potential clarifications to the underlying principle for classifying derivatives on own equity and <u>tentatively decided that</u> <u>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</u>. • In addition, the IASB <u>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</u>. • The IASB also tentatively decided <u>to provide guidance on the meaning of adjustments arising from preservation and passage of time</u>. o 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 o an entity would be required to classify derivatives on own equity as equity instruments if **passage of time adjustments** are pre-determined, vary only with the passage of time and fix the number of functional currency units per underlying equity instrument in terms of a present value.
Disclosures *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. • These potential refinements were focused on disclosures on: – Priority on liquidation – Potential dilution – Terms and conditions
Classification: Financial instruments with contingent settlement provisions *IASB November 2021 – February 2022*	• The IASB discussed the accounting for financial instruments that contain contingent settlement provisions, including: o classification and measurement of financial instruments with Contingent settlement provisions, including compound financial instruments (December 2021); o recognition of discretionary dividends (December 2021); o the meaning of 'liquidation' and 'non-genuine' (December 2021); o shareholder discretion (February 2022). • More details can be found in agenda paper 05-02
Classification: the effects of laws on contractual terms	• 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.

IASB September 2021 – December 2021	• More details can be found in agenda paper 05-02.
Reclassification: *IASB March 2022*	• The IASB explored what clarifications could potentially be made to IAS 32 on reclassification between financial liability and equity instruments. • More details can be found in agenda paper 05-03.

Feedback received from EFRAG Working Groups

EFRAG Financial Instruments Working Group

6 In January 2020, November 2021 and May 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 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).

EFRAG FR Technical Expert Group

7 In January 2020 and December 2020, EFRAG FR TEG and EFRAG FR TEG-CFSS received an update on the project and provided the following feedback:

(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.

8 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.

Questions for EFRAG FR TEG members

9 Does EFRAG FR TEG members have any general comments?

Agenda Papers

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

(c) Agenda paper 09-02 – Update on IASB discussions on contingencies and effects of law

(d) Agenda paper 09-03 – Update on IASB discussions - Reclassification