Financial Instruments with Characteristics of Equity
Update on IASB discussions

Objective

1 The objective of this agenda paper is to provide EFRAG FR TEG members an update on the IASB discussions, particularly on:

(a) contingent settlement provisions,

(b) the effects of laws on contractual terms; and

(c) shareholders discretion.

Contingent settlement provisions: compound financial instruments

2 After the 2008 global financial crisis, there has been an increase in the number of instruments issued by financial institutions that have loss absorption features using a contingent conversion mechanism. These instruments may have discretionary dividend features, which brings into question whether these instruments are compound instruments containing both equity and liability components.

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

4 At the time, the IFRS IC discussed five different alternative views that were being applied in practice. Some of these views are described below:

(a) ***View 1*: the instrument is classified as a liability in its entirety** in accordance with paragraphs 11 and 25 of IAS 32 *Financial Instruments: Presentation*. Any interest paid would be recognized in profit or loss;

(b) ***View 2*: The instrument is a compound instrument** in accordance with paragraph 28 of IAS 32. The value of the liability component would reflect the expected timing of the contingent non-viability event occurring, the equity component would reflect a residual value and any interest paid would be recognized in equity;

(c) ***View 3: The instrument is a compound instrument but the equity component has a value of zero*** – similar to view 2 but the liability component would be measured at the amount that the issuer could be required to pay immediately, the equity component (a residual) would have a value of zero and any interest paid would be recognized in equity.

5 At the time, the IFRS IC decided not to add this issue to its agenda. The IFRS IC noted that the scope of the issues raised in the submission was too broad for it to address in an efficient manner.

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

(a) *The order of applying the requirements in IAS 32*: When a compound financial instrument contains contingent settlement feature, the question that arises in

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

(i) *Potential clarifications*: require the compound instrument requirements (paragraphs 28-32 of IAS 32) apply first to identify the components of the financial instrument before any specific classification requirements (this is because paragraph 15 of IAS 32 already clarifies the order of applying the requirements in IAS 32).

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

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

(c) *Discretionary payments*: the question that arises in practice is how to account for discretionary interest or dividend payments if the entire proceeds are allocated to the liability component of a compound instrument, and whether there is an inconsistency between paragraphs 36 and AG37 of IAS 32.

(i) *Potential clarifications*: clarify that a compound instrument with a zero-value equity component is still a compound instrument with a liability (measured at the full amount that the issuer could be required to pay immediately) and an equity component (residual, which is zero). Thus, if the issuer pays any discretionary interest on the instrument, those payments relate to the equity component and would be recognised in equity (the requirement on dividends paid on compound instruments in paragraph AG37 of IAS 32 applies even if the equity component is initially measured at zero)

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

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

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

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

EFRAG Secretariat Analysis

8 The EFRAG Secretariat welcomes the IASB's discussions on contingent settlement provisions. The IASB's discussions are aligned with EFRAG request to the IASB to further work on:

(a) whether the measurement of the liability should reflect the probability-weighting of the liability component based on the likelihood of the liability settlement outcome occurring; and

(b) how to account for discretionary interest payments of a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent ‘non-viability’ event (paragraph 7(b) of EFRAG comment letter).

9 The EFRAG Secretariat assesses that applying the IASB’s tentative decisions to a financial instrument that is mandatorily convertible into a variable number of shares upon a contingent ‘non-viability’ event would mean that the issuer would:

(a) recognise a liability component, which reflects the issuer’s obligation to deliver a variable number of its own equity instruments if the contingent non-viability event occurs. The liability component would be measured at the full amount that the issuer could be required to pay immediately; and

(b) recognise an equity component, which reflects the issuer’s discretion to pay interest. The equity component would be measured as a residual and would be measured at zero because the instrument is issued at par and the value of the variable number of shares that will be delivered at conversion is equal to that fixed par amount. Any interest paid would be recognized in equity.

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

11 On the liability component, the EFRAG Secretariat notes that measuring a liability at a probability-weighted amount taking into account the likelihood and timing of the contingent event would secure a faithful representation and initial measurement of a liability component at fair value and thus eliminate structuring opportunities but would be a significant change to current requirements (and not simply a clarification). In addition, if the IASB were to require the measurement of such liabilities at a probability-weighted amount, significant judgement would be required and continuous reassessment would be needed if, and when probabilities change over time. Furthermore, it would require reconsideration of other provisions in IAS 32 that require liability treatment for obligations that are conditional on events or choices that are beyond the entity’s control (e.g., the treatment of puttable instruments that give the holder the right to put the instrument back to the issuer for cash or another financial asset).

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

Questions for EFRAG FR TEG

13 Do EFRAG FR TEG members agree with the EFRAG Secretariat analysis?

14 Do EFRAG FR TEG members have any other comments on the IASB tentative decisions?

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

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

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

(i) *Potential clarification*: specify that the term 'liquidation' in paragraph 25(b) of IAS 32, refers to when an entity has started the process to permanently cease to trade (as implied by the Conceptual Framework and IAS 1).

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

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

16 After considering these two issues, the IASB in December 2021 tentatively decided to propose amendments to IAS 32:

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

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

EFRAG Secretariat Analysis

17 In paragraph 10(c) of EFRAG comment letter to the IASB, EFRAG mentioned some of the challenges related to the wording 'liquidation'.

18 Thus, the EFRAG Secretariat welcomes additional guidance on the meaning of liquidation, which seems to be in line with the conceptual framework. The IASB's clarification has the benefit of bringing consistency and reducing diversity in practice to the classification of financial instruments that contain obligations that arise on events that may seem similar to, but are not, liquidation (e.g., resolution, restructuring, etc). Nonetheless, considering that different jurisdictions have different requirements for the liquidation process, the IASB should clearly explain the meaning of 'process of permanently ceasing operations', provide some examples and test it in practice. The EFRAG secretariat notices that the tentative

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

decision taken by the IASB allow for certain equity instruments not to take part in the risk and rewards of an entity through the liquidation process (i.e. holders of instruments classified as equity that receive a fixed amount at liquidation compared to a residual interest).

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

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

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

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

Questions for EFRAG FR TEG

23 Do EFRAG FR TEG members agree with the EFRAG Secretariat analysis?

24 Do EFRAG FR TEG members have any other comments on the IASB tentative decisions?

The effects of laws on contractual terms

25 Understanding the meaning of ‘contractual’ is a critical element for classification of a financial instrument as a financial liability or an equity instrument.

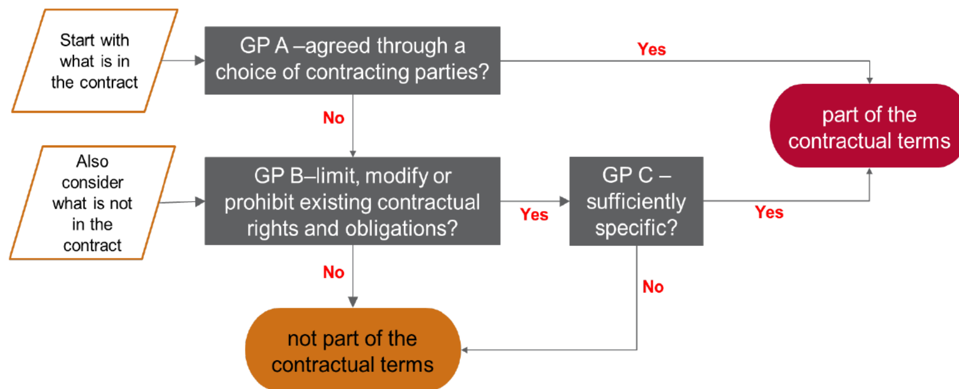
26 The overarching question is whether, and if so to what extent, a legal requirement is part of the contractual terms and must therefore be considered in classifying a financial instrument as a financial liability or an equity instrument. In particular, whether a legal requirement that is not reproduced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

27 Currently IFRS Standards are not consistent when dealing with the ‘contractual rights and obligations’ and ‘regulatory and legal’ requirements. For example, IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* considers the effects of legislative requirements for classification purposes while IFRS 9 *Financial Instruments* does not. In addition, paragraph 4.31 of the *Conceptual Framework for Financial Reporting* states that many obligations are established by contracts, legislation or similar means. The latter could indicate that even if an obligation is not established by contract, an obligation could arise as a result of the legislation.

28 The 2018 DP proposed no changes to IAS 32 on this topic. Some respondents who agreed with the IASB’s view noted that taking into consideration the overall effects of laws would represent a significant change to current requirements and could have

unintended consequences. However, most respondents urged the IASB to provide guidance on what should be considered as part of the contractual terms and whether, and how, an entity should consider the effects of relevant laws in classifying financial instruments, stating some deficiencies of a strict contract-only approach.

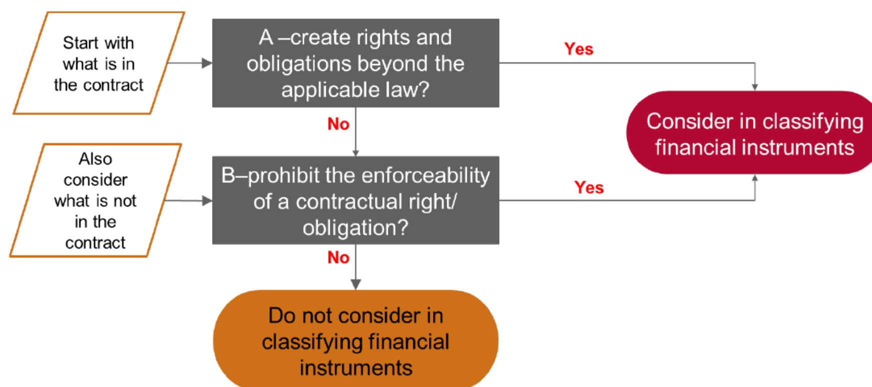
29 In September 2021, the IASB explored potential guiding principles to help determine whether legal requirements or terms that are required by law should be regarded as part of the contractual terms, regardless of whether being explicitly stated in the contract, and should be considered for classification purposes. More specifically, the IASB discussed the following potential guiding principles A, B and C:



30 In December 2021 the IASB discussed a refined principles approach where:

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

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



31 Thus, in classifying financial instruments under IAS 32, an entity would need to disregard some legal requirements even if they are stated in the contract. By contrast, an entity would need to consider some other legal requirements even if they are not stated in the contract. For example (more examples in appendix 1):

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

required by law. Thus, such terms should not be considered for classification purposes.

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

32 Such principles could be closely linked to the relevant requirements such as paragraph 13 of IAS 32, which describes what 'contract' and 'contractual' refer to in IAS 32.

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

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

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

EFRAG Secretariat Analysis

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

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

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

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

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

39 Finally, EFRAG welcomes that the IASB does not intend to reconsider the requirements in IFRIC 2 given that IFRIC 2 was developed for a very specific fact

pattern with limited effect in practice and that it is not aware of any challenges to its application.

Questions for EFRAG FR TEG

40 Do EFRAG FR TEG members agree with the EFRAG Secretariat analysis?

41 Do EFRAG FR TEG members have any other comments on the IASB tentative decisions?

Shareholders' discretion

42 In 2010, the IFRS IC received a request for guidance on whether a financial instrument, in the form of a preference share that includes a contractual obligation to deliver cash is a financial liability or equity if the payment is at the ultimate discretion of the issuer's shareholders.

43 More specifically, rights to declare dividends and redeem capital may depend on the decision made in a general shareholders' meeting, therefore the role of shareholders may be critical in deciding whether the entity has an unconditional right to avoid delivering cash. There are mixed views on this issue.

(a) Some take the view that if shareholders make decisions as part of the corporate governance decision-making process of the entity (generally exercised in a general meeting) this means that the entity has an unconditional right to avoid payment of cash and financial instruments such as preference shares should be classified as equity; and

(b) Some take the view that the actions of ordinary shareholders are not part of the entity's decision-making process and are outside the control of the issuing entity.

44 Thus, the IFRS IC identified that diversity may exist in practice in assessing 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, and consequently whether a financial instrument should be classified as a financial liability or equity.

45 At the time, the IFRS IC recommended that the IASB address this issue as part of its current project on FICE project. More specifically, discuss issues that arise in practice related to assessing when an event is within the entity's control and particularly, whether a decision taken by shareholders is within the entity's control (i.e. whether shareholders or other parties can be seen to represent the entity when they exercise their discretion or seen to represent themselves as shareholders).

46 This is particularly relevant when shareholders have discretion to initiate actions or when decisions made by management and the board of directors are subject to shareholder approval (e.g. perpetual equity instruments with fixed cumulative coupons or dividend stopper features).

47 In February 2022 the IASB discussed the possibility of:

(a) developing a single principle where routine shareholder decisions made as part of the entity's operating and corporate governance processes would be considered as within the entity's control; **or**

(b) developing factors (as potential application guidance in IAS 32) that may be relevant for an entity to consider in assessing whether a decision of shareholders is within the control of the entity in classifying financial instruments as financial liabilities or equity. The relevant factors may include but are not limited to:

(i) *type of decision* - whether the decision would be routine in nature and made as part of the entity's operating and corporate governance process;

(ii) *who would initiate the decision* - whether the decision would be initiated by management of the entity and subject to shareholders' approval rather than a decision that would be initiated by shareholders; and

(iii) *would different shareholders benefit differently from the decision* - whether different classes of shareholders would benefit differently from the decision made or whether shareholders are also the holders of the instruments being assessed.

48 After discussing this issue, the IASB tentatively decided to 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.

49 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.

50 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).

EFRAG Secretariat Analysis

51 The EFRAG welcomes that the IASB is discussing possible improvement to IAS 32 on payments at the ultimate discretion of the issuer's shareholders. The IASB's discussions are aligned with EFRAG request to the IASB to further work on whether a financial instrument in the form of a preference share that includes a contractual obligation to deliver cash is a financial liability or equity, if the payment is at the ultimate discretion of the issuer's shareholders (discussed by the IFRS IC in March 2010).

52 The EFRAG Secretariat acknowledges that there are mixed views on this issue and notes 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.

53 At this stage, the EFRAG Secretariat considers that if the IASB decides to provide guidance in this area, it should proceed very cautiously when developing factors that may be relevant for an entity to consider. This is because, such factors may have a high impact on current requirements and change significantly current practice.

54 For example, perpetual financial instruments typically contain obligations for which an entity has an unconditional right to defer cash payment until liquidation. IAS 32 classifies such financial instruments as equity instruments because there is no contractual obligation to transfer cash or another financial asset or to deliver a variable number of shares at a specified time other than at liquidation. However, some perpetual instruments include a contractual feature that will give investors in the instrument a right to vote at shareholders' meetings if the issuer does not pay the coupon for a specified period (dividend pusher). 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 such instruments (from equity to financial liabilities), having a significant impact on current practice.

55 Similarly, in some European jurisdictions there are protective rights that give a minority of the shareholders a possibility to 'force' the annual meeting to decide on the payment of dividends. 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 such instruments (from equity to financial liabilities), having a significant impact on current practice.

56 Therefore, the EFRAG Secretariat considers that, if the IASB decides to proceed with guidance in this area, it should make sure that the introduction of any new factors would not lead to the development of new principles that will result in fundamental changes to current requirements and practice.

Questions for EFRAG FR TEG

57 Do EFRAG FR TEG members agree with the EFRAG Secretariat analysis?

58 Do EFRAG FR TEG members have any other comments on the IASB tentative decisions?

Appendix 1 – table that summarises the results of applying the proposed principles[2] and the classification outcomes

Example instrument	Application of Principle A	Application of Principle B	Classification outcome
Bail-in instrument – Specific loss absorption feature (converting a fixed amount into a fixed number of shares)	Consider in classification—Contractual rights and obligations extend beyond the legal requirements	Not applicable (N/a)—the feature has been determined as relevant to classification applying Principle A	Equity—The specific loss absorption feature is considered but the general bail-in power is not
Bail-in instrument – General bail-in power	N/a—does not give rise to contractual rights and obligations beyond the legal requirements	Do not consider in classification—the law does not prohibit the enforceability of contractual rights and obligations	
Ordinary shares with statutory minimum dividends	N/a—does not give rise to contractual rights and obligations beyond the legal requirements	Do not consider in classification—the law does not prohibit the enforceability of contractual rights and obligations	Equity—no contractual obligation to deliver cash or another financial asset
IFRIC 2-type instruments	N/a—does not give rise to contractual rights and obligations beyond the legal requirements	Consider in classification—the law prohibits the enforceability of the redemption feature in the contract	Equity—the legal requirement effectively nullified the contractual obligation to redeem the instrument

[2] See paragraph 30 above.