IASB discussions: Reclassifications
Issues Paper

Objective

1 The objective of the paper is to update EFRAG FR TEG of the IASB's discussions in March 2022 on reclassifications of financial instruments in the FICE project.

Reclassifications

2 The IASB Staff prepared a paper that indicated that IAS 32 *Financial Instruments: Presentation* does not have requirements on reclassification between equity and financial liabilities.

3 The paper focusses on changes in substance of the contractual terms without a modification of the contract. Examples include loss of control over a previous subsidiary or a change in functional currency or expiry of an option or the fixing of a variable settlement term, i.e., it is now fixed. It does not consider reclassifications between standards such as from IFRS 2 *Share-based Payments* to IAS 32.

4 There were two IFRS IC discussions on reclassification in 2006 and 2021, whether:

(a) an amendment to the contractual terms of an equity instrument resulted in the instrument being classified as a financial liability of the issuer; and

(b) an issuer reclassifies a warrant as an equity instrument following the fixing of the warrant's exercise price after initial recognition as specified in the contract.

5 The following paragraphs are intended to provide FR TEG members with a guide to navigate the IASB Staff paper.

6 Examples mentioned (paragraphs 4 and 45) include:

(a) Change in circumstances such as a change in functional currency or losing control over a subsidiary; or

(b) A change due to the passage of time such as the expiry of an option or when variable settlement terms become fixed, for example:

(i) a warrant where the holder can buy a fixed number of equity instruments of the issuer of the warrant for an exercise price to be determined at a future date.

(ii) contingent consideration in business combinations to be settled in its own equity instruments but the number of shares will be fixed in the future.

(iii) a put option at a fixed strike for the first three years of the instrument's life and it expires unexercised at this point.

(iv) an instrument classified on the basis of a contingency for a specified period, but it does not take place during the specified period, or

(c) Settlement of linked instruments affecting the payments to be made on another instrument, for example where payments are made on a bond when dividends are paid on a class of preferential shares. If the bond is repaid, the

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substance of the preference shares contract has changed as it no longer contains a requirement to make payments.

7 The IASB Staff paper paragraphs 10 to 14 cover the reclassifications currently in IAS 32 such as puttable instruments and a forward or put on own shares.

8 In paragraphs 15 to 20, the paper considers requirements in related financial instrument accounting standards, such as IFRS 9 *Financial Instruments* as examples but no changes to these standards are proposed.

9 The results from informal outreach with large accounting firms is described in paragraphs 27 to 29 and these discussions reflect that practice has developed over time and diversity with some requiring and some permitting reclassification.

10 The IASB Staff then distinguishes between reclassification and the recognition of a new financial instrument following the derecognition of a financial liability. The former only applies when there is a change in classification without derecognition. (Paragraph 41).

11 The IASB Staff identified some frequent examples that arise in practice, and these are described in paragraph 45. The Staff then identified two potential approaches:

(a) The prohibition of reclassification; or

(b) Require reclassification.

12 The first may require consideration as to whether further disclosures are needed about the effects of such changes on the nature of the obligation. The latter would require reflecting the substance of the contractual terms of the financial instrument at the reporting date. This would also require further consideration in relation to the timing, measurement and disclosure of the reclassification.

IASB discussion

13 This was not a decision-making session and IASB members agreed that there was a gap that should be addressed and that there should not be an accounting policy choice leading to diversity in practice.

14 Many IASB members agreed that there is sufficient guidance in the current standards regarding modification of the contractual terms except for one member who disagreed using modification to equity as an example. However, the Staff countered that during the IFRS 9 PIR, this was not raised as a concern.

15 IASB members agreed that requiring reclassification would provide more useful information and reflect the economic substance. They also considered that it is closer to current practice and so would cause less disruption.

16 On the frequency of the reclassification assessment should be assessed, the IASB members agreed that further analysis is needed. Some considered that assessment on change would be sufficient and not necessarily required at each reporting period.

17 There was also agreement that the requirements would need to be explicit about remeasurement and presentation of the related gain or loss on reclassification.

EFRAG Secretariat analysis

18 The EFRAG Secretariat notes the following:

(a) Limiting accounting policy choices is always preferable, but given the absence of specific requirements, there is a *de facto* choice currently. This means that change for some will be difficult in either scenario.

(b) The IFRS 9 PIR is an unlikely place for constituents to mention reclassification of equity as a concern.

(c) Requirements on the related remeasurement and presentation on reclassification, would be essential to resolve the current issues on the topic.

19 The EFRAG Secretariat acknowledges that reclassification at period ends would improve the relevance of the information provided as it would reflect the economic and legal position as at that time. Furthermore, such up to date information would be useful given its improved relevance. Where the reclassification is well explained, it could add significant understanding of the changes and their impacts.

20 However, while in theory the reassessment of classification sounds very attractive as providing relevant information, paragraphs around changes to legislation (including taxation), group structure etc. are very prevalent in many types of contracts. Therefore, the burden that such an approach would introduce is likely to be significant. The EFRAG Secretariat would encourage the IASB Staff to obtain a better view of the potential implications of following such an approach before pursuing it further.

21 The EFRAG Secretariat is also not convinced that this approach is closer to current practice. At least some firms allow a policy choice and for convenience, maintaining the current classification could be a valid choice. Therefore, the EFRAG Secretariat is concerned that requiring reclassification could significantly increase the burden on preparers. While this is not the only consideration, the current information provided to the IASB is insufficient to base such an important decision on.

22 Given the complexity of a change in functional currency, this may benefit from explicit guidance of what is required. This includes reassessment of the classification of derivative contracts or contracts with embedded derivatives. Such guidance would be better placed in IAS 21 *The Effects of Changes in Foreign Exchange Rules* rather than in IAS 32.

23 Implementation of an amendment with respect to reclassification would need to be reconsidered after the decision in paragraph 11 has been made. Irrespective of the final IASB decision, the next steps should take into account that for some preparers this was a policy choice in the absence of clear guidance and the EFRAG Secretariat would therefore propose prospective application.

Questions for EFRAG FR TEG

24 Does EFRAG FR TEG have comments on the IASB paper or discussions?

25 Does EFRAG FR TEG have comments on the EFRAG Secretariat analysis?