UPDATE ON THE IASB'S PROJECT FICE

EFRAG TEG MEETING 24 NOVEMBER 2021

EFRAG
European Financial Reporting Advisory Group

DISCLAIMER

This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG TEG. 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. 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.

OVERVIEW

PROJECT OVERVIEW

FIXED-FOR-FIXED CONDITION

DISCLOSURES

OTHER TOPICS

PROJECT OVERVIEW

Objective and timeline

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

Q4 2019	Q2 2020	Q1 2021	Q2 2021	Q3 2021		TBD
Project plan agreed	Fixed-for-fixed condition discussion concluded	‘Perpetual instruments’ discussion started	Disclosures discussion concluded	Contingent settlement provisions and the effect of law discussions started	...	Exposure Draft
	Slides 7–10		Slides 13–16	Slide 20		

FIXED-FOR-FIXED CONDITION

Financial instruments settled in issuer’s own equity instruments (fixed-for-fixed condition)

- Two principles are proposed to meet ‘fixed-for-fixed’ condition in paragraph 16(b)(ii) of IAS 32
- Particular adjustments would not preclude equity classification if they meet the adjustment principle

Foundation principle

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

Adjustment principle

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

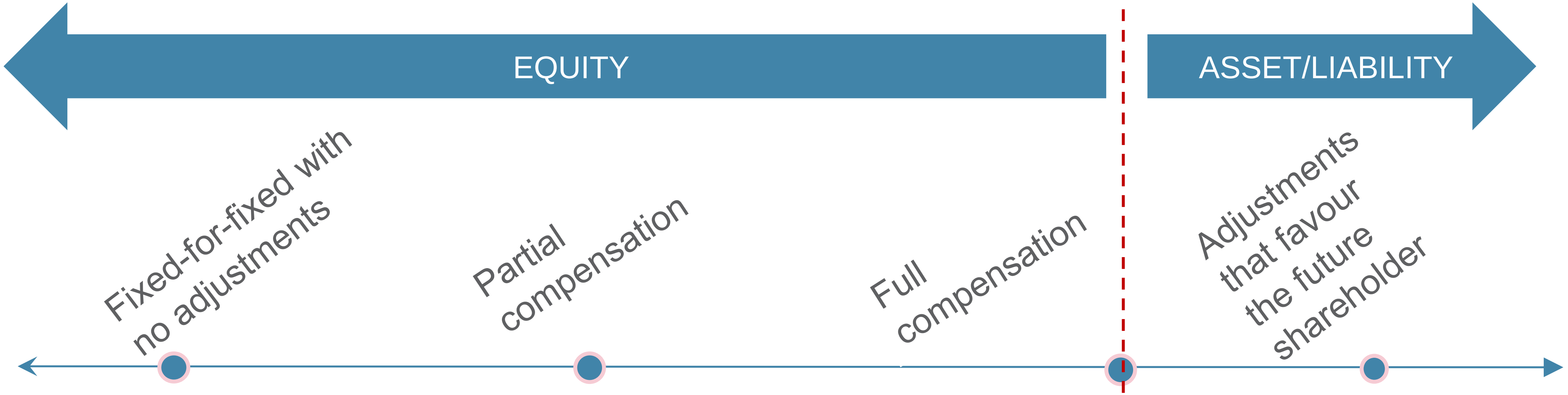
Foundation principle

Classify as equity if the number of functional currency units to be exchanged with each underlying equity instrument is fixed.

Examples	Classification
Fixed-for-fixed derivative A written call option that gives the holder a right to buy 100 of the company's own shares for CU100 in cash in five years	**Equity** The issuer knows how much cash it will receive for each share, ie CU1 per share.
A variable number of shares to a fixed value A written call option that gives the holder a right to buy as many of the company's own shares as are worth CU100 in exchange for CU95 in cash	**Financial liability** The issuer does not know how much cash it will receive for each share.

Allowable preservation adjustments

Classify as equity if preservation adjustments require the company to preserve the relative economic interests of future shareholders to an equal or a lesser extent than those of the existing shareholders



Eg CU100 for 100 shares

Eg CU100 for 100 shares with strike price adjusted for annual dividends but not for special dividends

Eg CU100 for 100 shares but strike price adjusted for annual dividends and special dividends

Eg ‘down round’ provision

Allowable passage-of-time adjustments

Classify as equity if passage-of-time adjustments:

- **are pre-determined and 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 (PV)**

Examples	Classification
Company A issues an option that can be exercised for predetermined amounts at predetermined dates: • 10 shares for CU100 at end of Year 1 • 10 shares for CU150 at end of Year 2 • 10 shares for CU500 at end of Year 3	**Likely to be a financial liability** Not likely to be an allowable adjustment because the contract does not fix the amount per share in terms of PV (PV at inception of CU150 in Year 2 is unlikely to be the same as PV at inception of CU500 in Year 3 applying the same discount rate)

FIXED-FOR-FIXED CONDITION

FOUNDATION PRINCIPLE

- The foundation principle captures the essence of the IAS 32 requirements as well as practice that has developed on this topic.
- The foundation principle in and of itself is not expected to change current practice. The expected portrayed outcomes agree to current practice/outcomes.
- The EFRAG Secretariat will continue to monitor any decisions around the ‘foreign currency rights issue’ exception

ADJUSTMENT PRINCIPLES

- In general, no significant changes in practice expected. The IASB tentative decisions would clarify the accounting for financial instruments that include preservation adjustments clauses (e.g. anti-dilutive financial instruments) or include passage of time adjustments (e.g. Bermudan options)
- The reasoning for the classification of financial instruments with a strike price that varies with an interest rate benchmark or an inflation index should be clarified. Is it due to interest on the strike price or because of the variable rate?
- Concerns about differentiating between preservation or passage of time adjustments and whether this distinction could give rise to different answers.
- Agreement that the symmetry considered under Alternative A would not have provided useful information to users and would have increased complexity in financial reporting

DISCLOSURES

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

Requirements

Highlight:

- 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)
- key features that determine classification

Disclosures - 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)

Requirements

- 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

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

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

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

DISCLOSURES

PRIORITY ON LIQUIDATION

- The IASB tentative decisions are, in general in line with EFRAG's suggestions included in its comment letter.
- In general, the EFRAG Secretariat agrees with the proposals but the following need to be considered:
    - Disclosures should consider both legal and contractual priority and not only focus only on terms and conditions
    - The wording 'liquidation' raises a number of challenges. For example, entities prepare financial statements on a going concern basis and real-life situations can be more complex than simply liquidation.

DISCLOSURES

POTENTIAL DILUTION

- The IASB tentative decisions are, in general in line with EFRAG's suggestions included in its comment letter.
- The EFRAG Secretariat welcomes the disclosure proposals and considers that information about potential dilution should be disclosed together with key terms and conditions that are relevant to understanding the potential dilution

TERMS AND CONDITIONS

- The IASB tentative decisions seem to be in line with EFRAG's proposals in its comment letter. In general, EFRAG FIWG and TEG comments on disclosure overload have been taken into account and the scope has been narrowed
- The EFRAG Secretariat welcomes limiting the disclosures but considers that the following should be considered:
    - It is key to define debt-like features or equity-like features or to provide additional guidance as in practice, it may be difficult to assess this
    - Important to provide information about early redemptions and incentives to pay, particularly for instruments with contingent settlement features

OTHER TOPICS

Other topics

	Board's discussion to date	
Perpetual instruments	• No change to classification • Presentation and disclosure requirements to be developed further	Discussion to continue at future Board meetings
Contingent settlement provisions (CSP)	• Topics discussed included: classification and measurement of financial instruments with CSP and recognition of discretionary dividends, shareholder discretion and the meaning of 'liquidation' and 'non-genuine'	
The effect of laws on the contractual terms	• Discussed potential guiding principles to determine whether the effect of laws are considered in classifying financial instruments	

CONTINGENT SETTLEMENT PROVISIONS

EFRAG SECRETARIAT ANALYSIS

- Welcomes discussions on possible improvements to IAS 32 to clarify the classification of financial instruments that are mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event. We consider that measuring a liability at a probability-weighted amount taking into account the likelihood and timing of the contingent event would be a significant change to current requirements
- Welcomes discussions on possible improvement to IAS 32 on the accounting for financial instruments in which the manner of settlement is conditional on rights within the control of the entity. In its comment letter, EFRAG considered that improvements to the indirect obligations requirements (e.g. incorporate the notion of 'no commercial substance' which is currently used in paragraph 41 of IFRS 2) may alleviate also some of the issues related to economic compulsion
- Welcomes discussions on possible improvement to IAS 32 on payments at the ultimate discretion of the issuer's shareholders. However, acknowledge that there are mixed views on this issue and developing guidance on how to determine when the shareholders are acting in their individual capacity may be difficult and subjective

EFFECTS OF LAWS AND REGULATIONS

EFRAG SECRETARIAT ANALYSIS

- 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. In particular, when considering bail-in instruments
- The EFRAG Secretariat is also not in favour of an all-inclusive 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
- The 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.
- 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.

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THANK YOU

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