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 tentatively decided that 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. • In addition, the IASB 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. • The IASB also tentatively decided to provide guidance on the meaning of adjustments arising from preservation and passage of time. 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. • More details in agenda paper 07-02.
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 • More details in agenda paper 07-02.
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);

	○ recognition of discretionary dividends (December 2021); ○ the meaning of 'liquidation' and 'non-genuine' (December 2021); ○ shareholder discretion (February 2021). • More details can be found in agenda paper 07-02
Classification: the effects of laws on contractual terms IASB September 2021 – December 2021	• 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. • More details can be found in agenda paper 07-02
Reclassification: **IASB March 2021**	• The IASB explored what clarifications could potentially be made to IAS 32 on reclassification between financial liability and equity instruments • To be discussed in a future session.

Feedback received from EFRAG Working Groups

EFRAG Financial Instruments Working Group

1 In January 2020 and November 2021, 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.

<u>*Fixed-for-fixed requirement*</u>

(b) 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.

(c) 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.

(d) 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.

(e) 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.

<u>*Disclosures*</u>

(f) *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.

(g) *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.

(h) *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.

(i) *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.

(j) 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.

(k) Finally, members suggested that the IASB should organise a field-test focused on disclosures once it has finalised the discussions on disclosures.

Other topics

(l) *Contingent settlement provisions*: considered 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 (and not simply a clarification);

(m) *The effects of laws on contractual terms*: welcomed the IASB's discussions 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.

EFRAG FR Technical Expert Group

2 In January 2020 and December 2020, EFRAG FR TEG 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.

Questions for EFRAG FR TEG-User Panel members

6 Does EFRAG FR TEG-User Panel members have any general comments?

Agenda Papers

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

(a) Agenda paper 06-02 – Update on IASB discussions