Financial Instruments with Characteristics of Equity
Sweep Issues

Objective

1 The objective of this agenda paper is to provide an update on the IASB's tentative decisions related to sweep issues on classification and presentation topics included in the Financial Instruments with Characteristics of Equity (FICE) project plan.

Sweep issues

2 In its February 2023 meeting, the IASB discussed a number of sweep issues that the IASB staff became aware of subsequent to the IASB's discussions in 2020-2022 on classification and presentation topics included in the Financial Instruments with Characteristics of Equity (FICE) project plan.

3 In the agenda papers, the IASB staff made specific recommendations with regard to the fixed-for-fixed condition, reclassification, the effects of laws on contractual terms, obligations to redeem own equity instruments, and presentation of financial liabilities and equity instruments.

Topic and issue	IASB Staff recommendation
Clarifications on the fixed-for-fixed condition (foundation principle): There are questions on what the classification of convertible bonds would be when the holder has a choice between two fixed conversion ratios, each involving a different type of own shares (e.g. a holder has the right to convert its bonds, at any time before maturity, into either 100 shares of the parent or 1.100 shares of the issuing subsidiary).	**Foundation principle**: 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 or passage of time adjustments. **IASB Staff recommendation**: The foundation principle is met if the entity knows how many functional currency units it is entitled to receive <u>per type of own share</u> if the option is exercised.
Reference to reclassification: In June 2022 the IASB tentatively decided to add general requirements on reclassification to IAS 32 to prohibit reclassification other than for changes in the substance of the contractual terms arising from changes in circumstances outside the contract.	In February 2022, the IASB staff noted that reclassification is also mentioned in paragraph 23 of IAS 32 which discusses the accounting on initial recognition and **expiry (derecognition)** of a contract containing an obligation for an entity to purchase its own equity instruments for cash or another financial asset. **IASB Staff recommendation:** To avoid the term 'reclassification' being used inconsistently

In addition, the IASB also tentatively decided to provide clarifications related to the measurement and timing of reclassifications.	in IAS 32 (paragraph 23 of IAS 32 vs. the IASB's tentative decision), the IASB staff proposed to replacing in paragraph 23 of IAS 32 the terms 'reclassified' and 'reclassification' with 'transfer' and 'transferred'.
Date of reclassification: In June 2022, the IASB tentatively decided to clarify that a reclassification applying the proposed general requirements would be accounted for in the reporting period in which the change in circumstances occurred (e.g., changes in an entity's functional currency or changes to the entity's organisational structure). However, the IASB did not reach a decision on whether to require reclassification at the date of the change in circumstances or at the end of the reporting period.	**IASB Staff recommendation:** Reclassify at the date of the change in circumstances, as it would provide information to users that is both relevant and most faithfully represents the substance of the contractual terms, throughout the reporting period and not just at the reporting date. However, ask a question in the forthcoming ED to see if there are any practical considerations.
Simplifying the proposals on the effects of laws on the contractual terms: In December 2021 the IASB tentatively decided to require an entity to classify financial instruments as financial liabilities or equity by (i) (i) considering 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 (ii) applicable laws that prevent the enforceability of a contractual right or a contractual obligation. ASAF members expressed concerns that the proposed framework is complex (e.g. there is a perceived inconsistency between laws creating obligations and those preventing obligations and it would be a challenge for entities to keep track of all laws that could affect the classification).	**IASB's staff proposal**: Simplify the proposed principles by only requiring that financial instruments are classified as financial liabilities or equity by considering <u>enforceable contractual terms</u> that give rise to rights and obligations that are in addition to, or more specific than, those established by applicable law. That is, not include the requirement for entities to consider "applicable laws that prevent the enforceability of a contractual right or a contractual obligation", because enforceability by law is already implicit in the description of 'contractual' in paragraph 13 of IAS 32
Clarifications on the accounting for the obligations to redeem own equity instruments: In September 2022, the IASB tentatively decided to provide guidance on the accounting for obligations to redeem own equity instruments on initial recognition and expiry when obligation involves non-controlling interests (e.g., the debit entry is recognised against a component of equity other than non-controlling interests). However, the IASB Staff received feedback that paragraph 23 of IAS 32 is not explicitly clear on where the remeasurement gains or losses on these financial liabilities are recognised, ie in equity or profit or loss.	**IASB's staff proposal**: *Remeasurements of the financial liability:* Clarify in paragraph 23 of IAS 32 that gains or losses on remeasuring the financial liability are recognised in profit or loss. *Initial and subsequent measurement:* Clarify the same measurement approach would apply initially and subsequently for financial liabilities in the scope of paragraphs 23 (ie probability and estimated timing of settlement of the holder exercising the written put option is not considered in its initial and subsequent measurement). *Remove reference to IFRS 9*: Remove reference to IFRS 9 *Financial Instruments* for subsequent measurement from paragraph 23

	of IAS 32 (to avoid any confusion and reduce diversity in practice about how to calculate the carrying amount of the financial liability subsequently).
Clarifications on the accounting for instruments containing contingent settlement provisions: In December 2021, the IASB tentatively decided 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. The probability of the contingent event occurring is not considered in measuring the instrument on initial recognition. Paragraph 25 of IAS 32 itself does not explain how the liability should be measured initially or subsequently. Therefore, questions still remain for example, whether the liability would remain measured at the full amount of the conditional obligation subsequently or whether the probability and estimate of the timing of the contingent event occurring could be considered	**IASB's staff proposal**: Clarify the same measurement approach would apply initially and subsequently for financial liabilities in the scope of paragraph 25 of IAS 32, i.e. probability and estimated timing of the contingent event occurring or not occurring is not considered in its initial and subsequent measurement
Presentation of financial liabilities containing contractual obligations to pay amounts based on the entity's performance or changes in the entity's net assets: Paragraph 41 of IAS 32 states "Gains and losses related to changes in the carrying amount of a financial liability are recognised as income or expense in profit or loss even when they relate to an instrument that includes a right to the residual interest in the assets of the entity in exchange for cash or another financial asset (e.g. a financial instrument that gives the holder the right to put it back to the issuer for cash or another financial asset). Under IAS 1 the entity presents any gain or loss arising from remeasurement of such an instrument separately in the statement of comprehensive income when it is relevant in explaining the entity's performance.	**IASB's staff proposal**: Delete the second sentence of paragraph 41 of IAS 32 and add a cross-reference to paragraph 85 of IAS 1. This to avoid any perceived duplication of requirements when considering the IASB's tentative decision to disclose, in each reporting period, the total gains or losses that arise from remeasuring financial liabilities based on the entity's performance or changes in the entity's net assets or any inconsistency when considering that the IASB decided against adding separate presentation requirements in IAS 1 for these types of financial liabilities.

Shareholders discretion

4 In addition to the issues above, in previous meetings the IASB discussed the classification of a financial instrument with a contractual obligation to deliver cash (or to settle it in such a way that it would be a financial liability) at the discretion of the issuer's shareholders.

5 In those previous meetings, 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. 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.

6 In February 2023 the IASB Staff proposed the following wording for the factors-based approach:

Factors that an entity could consider when making that assessment include:

(a) *whether a shareholder decision would be routine in nature, that is, in the normal course of the entity's business activities in accordance with the entity's established operating and corporate governance procedures;*

(b) *whether a shareholder decision relates to an action that would be proposed by the entity's management;*

(c) *whether different classes of shareholders would benefit differently from a shareholder decision;*

(d) *whether the exercise of a shareholder decision-making right would enable those shareholders to require redemption of (or payment of a return on) their shares in cash or another financial asset (or other settlement in such a way that it would be a financial liability).*

The factors set out are examples of factors that an entity ***could*** *consider when assessing whether a shareholder decision is treated as a decision of the entity. Other factors may be pertinent to that assessment. The weightings applied to each factor when making that assessment depends on the specific facts and circumstances.*

7 The risk of entities manipulating the assessment (ie disregarding these factors even when they are relevant) to achieve a desired classification outcome would be mitigated by:

(a) the requirement in paragraph 122 of IAS 1 *Presentation of Financial Statements* to disclose the judgements that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

(b) potential additional disclosures to IFRS 7 *Financial Instruments: Disclosures* to require entities to disclose particular judgements made in classifying issued financial instruments.

The IASB discussions and tentative decisions

8 In February 2023, the IASB discussed the sweep issues identified above. After considering the IASB staff recommendations as presented above, the IASB tentatively decided:

Fixed-for-fixed condition

9 The IASB discussed how an entity would apply the fixed-for-fixed condition in classifying convertible bonds if the holder had a choice between two fixed conversion ratios with different types of own shares.

10 The IASB tentatively decided to amend the foundation principle which clarifies when the fixed-for-fixed condition is met. The foundation principle, as amended, states the condition is met if the entity knows how many functional currency units it will exchange per type of own share if the option is exercised.

Reclassification

11 The IASB discussed the need for consistency in the use of the term 'reclassification' in IAS 32 and when an entity (applying the proposed general requirements

tentatively agreed in June 2022) would account for a reclassification between financial liabilities and equity instruments. The IASB tentatively decided:

(a) to replace 'reclassified' and 'reclassification' with alternative wording in paragraph 23 of IAS 32.

(b) to require an entity to make a reclassification at the date of the change in circumstances that necessitated the reclassification. However, the IASB will ask a question in the forthcoming exposure draft to assess the practical considerations of this requirement.

The effects of laws on the contractual terms

12 The IASB discussed stakeholder feedback on the proposed principles (tentatively agreed in December 2021) that an entity would be required to apply in determining whether rights and obligations arising from a legal requirement are considered in classifying a financial instrument as a financial liability or equity instrument.

13 The IASB tentatively decided to simplify the proposed principles by requiring an entity to consider, in classifying a financial instrument, only enforceable contractual terms that give rise to rights and obligations in addition to, or more specific than, those established by applicable law.

Obligations to redeem own equity instruments

14 The IASB discussed whether to amend IAS 32:

(a) to clarify further the requirements on accounting for financial instruments containing obligations for an entity to redeem its own equity instruments, including written put options on non-controlling interests; and

(b) to ensure consistency between these requirements and the requirements on accounting for financial instruments containing contingent settlement provisions in paragraph 25 of IAS 32.

15 The IASB tentatively decided:

(a) to clarify in paragraph 23 of IAS 32 that, when remeasuring the financial liability, an entity is required to recognise gains or losses in profit or loss;

(b) to clarify that an entity is required to use the same approach for initial and subsequent measurement of financial liabilities within the scope of paragraph 23 of IAS 32—that is, the entity would ignore the probability and estimated timing of the holder exercising the written put option in initial and subsequent measurement;

(c) to clarify that an entity is required to use the same approach for initial and subsequent measurement of financial liabilities within the scope of paragraph 25 of IAS 32—that is, the entity would ignore the probability and estimated timing of the contingent event in initial and subsequent measurement; and

(d) to remove from paragraph 23 of IAS 32 the reference to IFRS 9 *Financial Instruments* about subsequent measurement.

Presentation of financial liabilities containing contractual obligations to pay amounts based on an entity's performance or changes in the entity's net assets

16 The IASB discussed how the proposed disclosure requirement tentatively agreed in December 2022 relates to the presentation requirement in paragraph 41 of IAS 32.

17 The IASB tentatively decided to delete the second sentence of paragraph 41 of IAS 32.

<u>Shareholder discretion</u>

18 The IASB also discussed how to articulate the proposed factors an entity considers in assessing whether a shareholder decision is treated as an entity decision. This assessment is necessary to determine whether the 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). The IASB had tentatively agreed to the proposed factors in February 2022; therefore, it was not asked to make any further decisions.

EFRAG secretariat analysis/recommendation

<u>Fixed-for-fixed condition</u>

19 The EFRAG Secretariat welcomes the IASB's tentative decision which will clarify how the foundation principle should be applied to convertible bonds would be when the holder has a choice between two fixed conversion ratios, each involving a different type of own shares.

<u>Reclassification</u>

20 The EFRAG Secretariat welcomes the IASB's tentative decision to require reclassification on the date of the change in circumstances and include a question in the forthcoming exposure draft to assess the practical considerations of this requirement.

<u>The effects of laws on the contractual terms</u>

21 The EFRAG Secretariat is concerned about the deletion of the principle "applicable laws that prevent the enforceability of a contractual right or a contractual obligation" as this was principle was key for IFRIC 2-type instrument.

22 Stakeholders often refer to IFRIC 2 instruments as an example of a situation in which classification of financial instruments considers the effects of relevant laws. Thus, it is important to explain how the revised proposed guiding principles would apply to these types of instruments or be explicit that the guidance in IFRIC 2 is not compatible with the proposed guiding principles.

23 Regarding the principle "applicable laws that prevent the enforceability of a contractual right or a contractual obligation", the EFRAG Secretariat highlights that taking into account the effects of laws that prohibit contractual rights or obligations is consistent with the conclusions in IFRIC 2. 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.

24 Considering this, the EFRAG Secretariat would like to see how the revised principle ('*to an entity to consider, in classifying a financial instrument, only enforceable contractual terms that give rise to rights and obligations in addition to, or more specific than, those established by applicable law*') would apply in practice to IFRIC 2-type instruments and this should be tested in practice.

25 The contractual terms of some instruments may rely significantly on current law. The EFRAG Secretariat is concerned that the requirement "financial instruments are classified as financial liabilities or equity by considering enforceable contractual terms that give rise to rights and obligations that are in addition to, or more specific than, those established by applicable law" may continue to cause a technical problem in classifying instruments that are included in contracts that rely significantly on local law..

Obligations to redeem own equity instruments

26 The EFRAG Secretariat welcomes the clarifications.

Shareholder discretion

27 The EFRAG Secretariat notes that there are mixed views on this issue and notes the difficulty and subjectivity of developing guidance on how to determine when the shareholders are acting in their individual capacity.

28 If the IASB decides to proceed, it should be cautious as it may have a significant impacts on current requirements and practice. For example, there is a risk that it may lead to less equity if shareholders' decisions are considered not on behalf of the entity in cases such as forced payment of dividends by minority shareholders or payment of interest of perpetual instruments that depend on payment of dividend. It may also lead to management making a judgemental decision in which capacity shareholders have voted and disclosing how they see shareholders decisions, whether shareholders are acting on behalf of the entity or as independent shareholders.

Questions for EFRAG FR TEG

29 Do EFRAG FR TEG members have any comments on the IASB's tentative decisions?

30 Do EFRAG FR TEG members agree with EFRAG Secretariat Analysis?