Applying IFRS

Financial instruments with characteristics of equity (FICE)

June 2022

Building a better working world

Contents

What you need to know

- The IASB's FICE project seeks to address issues that arise in applying IAS 32 *Financial Instruments: Presentation* and to expand the disclosure requirements relating to issued financial instruments.
- The IASB has now mostly completed its initial discussions, hence, we can anticipate many of the proposals that are likely to appear in its Exposure Draft (ED) on the subject
- No date has yet been set for issuing the ED.

Introduction

The International Accounting Standards Board (the IASB or the Board) has, in the past, issued two Discussion Papers[1], seeking to improve IAS 32 *Financial Instruments: Presentation* on the classification of issued financial instruments, as equity or liabilities. In both cases, this involved seeking to establish new principles. However, based on feedback received, the Board resolved not to rewrite the standard fundamentally, but only to:

- Address known practice issues that arise when applying IAS 32

  And

- Improve the information provided in the financial statements about the financial instruments issued by the entity

A new FICE project was started in 2020. Many of the components of the project have now been discussed and many decisions have tentatively been agreed. The remaining topics are planned to be discussed in 2022, but the possible date for the issue of an Exposure Draft (the ED) has yet to be set.

This publication summarises the tentative decisions made so far.

How we see it

We applaud the Board for seeking to clarify IAS 32 and provide more guidance, which should generally support current practice and lead to greater consistency of application. As with any ED, it is important that constituents review the wording carefully and field test the proposals to ensure they are clear and operable. It is important, for instance, that there is enough guidance to assess what is material and relevant, to ensure the new disclosures are proportionate and do not lead to overload.

[1] In 2008 and 2018.

1.Fixed for fixed

In April 2020, the Board tentatively decided that:

- For a derivative on own equity to meet the fixed-for-fixed condition in IAS 32 and hence qualify to be classified as equity, the number of functional currency units to be exchanged with each underlying equity instrument must be fixed or only vary with:
  a. "allowable preservation adjustments"; or
  b. "allowable passage of time adjustments"; and in addition
- 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.

Allowable preservation adjustments are those that require the entity to preserve the relative economic interests of the holders of the derivative (who will be future shareholders) to an equal or lesser extent than those of the existing shareholders. This would include adjustments to the terms of the derivative, such as to reflect stock splits, bonus issues of shares and abnormal dividends paid on the existing shares. An adjustment which is more favourable to the derivative holder than changes in the interests of existing shareholders would not be allowable.

Allowable passage of time adjustments are those that:

- 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

How we see it

The clarifications are welcome, as they are largely consistent with developed practice, but will also provide a more robust framework to support it. Note that there is no intention to change the requirement that 'fixed' refers to in the entity's functional currency.

2.Obligations that arise only on liquidation of the entity

In February 2021, the Board discussed challenges in accounting for financial instruments with obligations that arise only on liquidation of an entity. The Board also discussed potential classification, presentation and disclosure requirements to address those challenges. It tentatively decided not to change how such instruments should be classified, but instead to develop presentation and disclosure requirements in relation to them (see below).

3. Disclosures

The Board discussed potential refinements to the disclosure requirements in April and May 2021. In doing so, it considered the feedback from stakeholders on the proposals included in the ED, the feedback received in additional outreach activities focused on disclosures and the IASB Staff's research on regulatory disclosures provided by banks and insurers.

These potential refinements are focused on disclosures on:

- Terms and conditions
- Priority of claims, with a twofold approach based on:
  - The nature and priority of claims against the entity; and
  - Terms and conditions for priority on liquidation for specific instruments; and
- Potential dilution

3.1. Terms and conditions

The Board tentatively decided that, for financial instruments with characteristics of both financial liabilities and equity instruments (except for stand-alone derivatives), an entity would be required to disclose in the notes to the financial statements, information about:

- 'debt-like features' in financial instruments that are classified as equity instruments (for example, fixed coupons payable on a preference share, but only if dividends are paid on ordinary shares, or subordinated debt where the holder has higher risk of not recovering the full contractual cash flows should the issuer be liquidated)
- 'equity-like features' in financial instruments that are classified as financial liabilities (for example, derivatives on own equity that do not meet the fixed for fixed criterion, or 'write-down bonds', where the principal is reduced if the issuer's capital falls below a trigger level)
- Debt-like and equity-like features that determine the classification of such financial instruments as financial liabilities, equity instruments or compound financial instruments

Key cash flow characteristics of 'typical' financial liabilities are specified timing and fixed or determinable amounts whereas the key cash flow characteristics of 'typical' equity instruments are unspecified timing and unspecified amounts.

3.2. Priority of claims

3.2.1. The nature and priority of claims against an entity

In order to help investors better understand an entity's capital structure and the quality of different categories of capital, the Board tentatively decided to require:

- An entity to disclose and categorise in the notes to the financial statements, its issued financial instruments in a way that reflects differences in their nature and priority, and at a minimum, to distinguish between:
  - i. Secured and unsecured financial instruments
  - ii. Contractually subordinated and unsubordinated financial instruments

iii. Those issued or owed by the parent and those issued or owed by subsidiaries

And

- These disclosures are to be made for all financial liabilities as well as equity instruments that are within the scope of IAS 32.

In contrast with the disclosures covered in section 3.2.2. below, the objective of this disclosure is not to provide information about the priority of individual instruments on liquidation, but rather a categorisation of the capital structure to show differences in the quality of capital within the capital structure. As a result, the information can be provided on a consolidated and aggregated basis.

3.2.2. Terms and conditions for priority on liquidation for particular financial instruments

The Board tentatively decided to also require an entity to disclose more granular information about priority on liquidation for financial instruments with characteristics of both debt and equity, including compound instruments, but excluding stand-alone derivative instruments (which is the same scope as for terms and conditions described in section 3.1.). This priority information should be provided as part of the terms and conditions disclosures mentioned in section 3.1. above and should include the following:

- Terms and conditions that indicate priority on liquidation
- Terms and conditions that could lead to changes in priority on liquidation
- That a particular type of financial instrument has more than one level of contractual subordination, if applicable (for example, if some subordinated notes rank junior to other subordinated notes or in securitisations where instruments are issued in multiple tranches, each having a subordination ranking); in this way, investors are alerted and can decide whether to perform further analysis by reviewing the underlying documents
- Narrative information when an entity is aware of significant uncertainty about the application of relevant laws or regulations that could affect how priority will be determined on liquidation
- Details of intra-group arrangements, such as guarantees, that may affect their priority on liquidation (for example, which entities are providing and receiving guarantees)

3.3. Potential dilution

In order to enable users of financial statements to assess the potential dilution of ordinary shares arising from financial instruments that could be settled by delivering ordinary shares, for example, convertible bonds and derivatives on own equity, the Board tentatively decided to require an entity to disclose information about the maximum dilution of ordinary shares. This disclosure would be in addition to the normal IAS 33 *Earnings per share* diluted earnings per share. It includes:

- The maximum number of additional ordinary shares that an entity could be required to deliver for each type of potential ordinary share outstanding at the reporting date. An entity would:

i. Include the total number of share options outstanding (as required, for instance, to be disclosed by IFRS 2 *Share-based Payment*) and the number of unvested shares, if known (see below)

And

ii. Indicate the possibility for unknown dilution where the maximum number of additional ordinary shares that could be delivered is "not yet known"

- The minimum number of ordinary shares required to be repurchased
- Sources of any significant changes in the maximum and minimum numbers of shares that the entity could be required to deliver from the prior reporting period and how these sources contributed to those changes
- Terms and conditions relevant to understanding the likelihood of maximum dilution, including a cross-reference to disclosures required by IFRS 2 for a description of share-based payment arrangements
- A description of any share buy-back programmes or other arrangements that may reduce the number of shares outstanding

Such information would help in understanding how the entity distributes its returns to ordinary shareholders, how the entity has financed its operations in the past, and how the entity's capital structure might change in the future based on the instruments issued at the reporting date.

The Staff Paper gave two examples of where the number of shares that could be delivered are not yet known:

- A company offers 100 of its employees the opportunity to participate in an employee share purchase plan, in which the employees can choose to contribute up to 2% of their gross monthly salary, for a period of 24 consecutive months. The number of shares to be purchased depends on a number of as yet unknown factors, including the employees' decisions to invest and their salaries over the 24-month period.
- In some share-based payment transactions, the employee can choose settlement in shares or cash at a future date. Therefore, the amount of cash or number of shares may not be known at the reporting date.

How we see it

- These proposals will, collectively, add significantly to an issuer's disclosure obligations. It is important that issuers examine the proposals carefully, so that the costs of compliance can be adequately assessed and compared against the perceived benefits to users. Field testing of the proposals may also be warranted.
- It would be helpful to establish a principle to distinguish between debt and equity-like features, including in the event of liquidation, especially given the level of innovation in the capital markets and, hence, the likelihood of the emergence of new features in the future.
- The disclosures about priority on liquidation refer to an instrument's contractual terms and not to the effect of laws and regulations (unless there is significant uncertainty about how they would be applied). Therefore, there is a risk that the information that would be required to be disclosed would provide an incomplete picture of the priorities of an

entity's capital structure in the event of liquidation, especially for international groups with operations governed by a variety of laws and regulations.

- The disclosures about priority on liquidation would also appear to ignore regulatory resolution, about which the provision of further information would be justified.

4.Instruments with contingent settlement provisions

In December 2021 the Board tentatively decided that the standard will be amended:

- To clarify that financial instruments with contingent settlement provisions may be compound instruments
- 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
- To clarify that payments at the discretion of the issuer (such as dividends) are recognised in equity, even if all the proceeds are initially allocated to the liability component of a compound financial instrument
- 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

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

How we see it

The second of these proposals, on provisions which require immediate settlement if a contingent event occurs, is consistent with a view initially taken by the IFRS Interpretations Committee (IFRS IC)in July 2013. The instrument they considered had no stated maturity date and any interest was payable only at the discretion of the issuer, but it was mandatorily convertible into a variable number of shares equal to the par value in the event that the issuer breached its Tier 1 capital ratio. However, after receiving comment letters expressing the view that the standard is unclear, the IFRS IC decided the issue was too broad to be addressed in an efficient manner. Hence, there is currently diversity in practice. Arguably this proposal is more than just a clarification; the other proposed clarifications largely reflect current practice.

5. The effect of laws

In December 2021, the Board tentatively decided that, to classify an instrument as equity or liability an issuer should consider:

- 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 (so that, for instance, terms set out in applicable law, such as a requirement to pay a minimum percentage of profits as a dividend, may be ignored and so would not lead to the instrument being classified as a liability)

And

- Applicable laws that prevent the enforceability of a contractual right or a contractual obligation (such as the possible legal constraint on a shareholders' redemption option in IFRIC 2 *Members' shares in co-operative entities* and similar instruments, so that the shares would be recognised as equity, despite the contractual redemption option)

How we see it

The combined effect of these two proposed amendments would be consistent with both what the IASB has previously proposed in the FICE project and IFRIC 2. It is expected to be generally consistent with current practice.

6. Shareholders' discretion

In February 2022, 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.

The IASB tentatively decided to explore a factor-based approach to help an entity apply 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. 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).

The Staff Paper prepared for the Board meeting gave examples of the potential factors to be considered, each of which would not be determinative on its own:

- Whether shareholder decision is a routine part of the operating and corporate governance process (e.g., the approval of dividends at an annual general meeting) or not (e.g., the approval of a change of control, which will often occur at a 'special' meeting and require more than a simple majority)
- Who initiates, whether management, so that shareholders merely approve or reject management's proposals, or the shareholders or third parties
- Whether the issue affects different share classes differently, so that, for example, discretion by preference shareholders would be treated as indicative of a liability and separate voting by class would suggest voting as a class and not as part of the entity.

How we see it

This is an area that is currently unclear and where practice is varied. The proposed approach seems more restrictive than some current practice, for instance, by distinguishing between voting at an ordinary meeting versus a special meeting and also by considering who initiates the proposal. By providing examples of factors to consider, judgement will continue to be required.

7. Reclassifications

In March 2022, the IASB discussed whether IAS 32 permits or requires reclassification after initial recognition. The IASB was not asked to make any decisions.

The Staff Paper presented to the Board made it clear that reclassification is not the same as derecognition of one instrument and recognition of another. Derecognition is outside the scope of this project, although the Staff Paper appears to favour application of the liability derecognition rule, whereby a modification would lead to derecognition if 'substantial'. The focus of the Staff Paper is on when a change in circumstances leads to a change in the substance of the contractual terms, without the contract being modified. This might, for instance, include the passage of time, a change of functional currency, a change of control, or a change in the law.

The Staff suggest there are two possible approaches: either to prohibit reclassification, or to require it.

If an instrument classified as equity were to be reclassified to a liability, any gain or loss would be recognised in equity. The accounting has not yet been considered for where a liability is reclassified to become equity.

How we see it

Guidance in this area would be very valuable since IAS 32 is currently silent on this subject and there is diversity in practice.

8. Further items scheduled to be discussed

The following are planned to be discussed during 2022:

- Reclassifications (completion)
- Obligations to redeem own equity instruments (e.g., put options on non-controlling interests)
- Other related matters such as transition
- Presentation (including presentation for obligations that arise only on liquidation)
- Any further disclosure requirements

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