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Exposure Draft

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Basis for Conclusions on Financial Instruments with Characteristics of Equity

Proposed amendments to IAS 32, IFRS 7 and IAS 1

Comments to be received by 29 March 2024

International Accounting Standards Board

IASB/ED/2023/5

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This Basis for Conclusions accompanies the Exposure Draft IASB/ED/2023/5 which is published by the International Accounting Standards Board (IASB) for comment only. Comments need to be received by **29 March 2024** and should be submitted by email to commentletters@ifrs.org or online at https://www.ifrs.org/projects/open-for-comment/.

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Basis for Conclusions on Exposure Draft *Financial Instruments with Characteristics of Equity*

This Basis for Conclusions accompanies, but is not part of, Exposure Draft Financial Instruments with Characteristics of Equity. *It summarises the considerations of the International Accounting Standards Board (Board) when developing the Exposure Draft. Individual Board members gave greater weight to some factors than to others.*

Background

BC1 IAS 32 *Financial Instruments: Presentation* sets out requirements for classifying and presenting financial instruments as financial liabilities or equity instruments in the financial statements of the issuer of those instruments.

BC2 The Board considered some aspects of distinguishing liabilities from equity instruments in its project to revise the *Conceptual Framework for Financial Reporting* (*Conceptual Framework*). As part of that project, the Board decided that the *Conceptual Framework* would continue to make a binary distinction between liabilities and equity. In 2014 the Board decided to explore further how to distinguish liabilities from equity as part of a separate project on *Financial Instruments with Characteristics of Equity* that would focus on financial instruments and aim to investigate, and suggest solutions to, the specific challenges faced by entities in distinguishing financial liabilities from equity instruments in applying IAS 32. Consequently, the 2018 *Conceptual Framework* does not address classification of financial instruments with characteristics of equity.

BC3 The Board published the Discussion Paper *Financial Instruments with Characteristics of Equity* in June 2018 (the 2018 Discussion Paper). The Board noted that the requirements in IAS 32 have been applied without difficulty in classifying the majority of financial instruments. The Board also noted that the application of the requirements in IAS 32 results in classification outcomes that provide useful information to users of financial statements. Furthermore, the Board was not aware of any evidence to suggest that there were fundamental problems with IAS 32 during the global financial crisis of 2007–8.

BC4 However, financial innovation, market forces and changes to financial sector regulations have resulted in a growing number of financial instruments with characteristics of equity that present challenges to entities in applying IAS 32. Users of financial statements who wish to understand the effects of these financial instruments on an entity's financial position and financial performance have raised questions about their classification. The Board has also become aware of IAS 32 application challenges faced by entities that have been highlighted in submissions to the IFRS Interpretations Committee. The Committee was unable to reach a consensus on some of these submissions because it was difficult to identify a clear and consistent classification principle in IAS 32. These application challenges have resulted in diversity in practice, which reduces the comparability and understandability of financial statements. Users of financial statements have also expressed concerns about the limited information about various features of those instruments provided through presentation and disclosure.

BC5 To respond to these challenges, the Board proposed—in the 2018 Discussion Paper—an approach that was intended:

(a) to articulate the principles for classifying financial instruments as either financial liabilities or equity instruments with a clear rationale, without substantially changing the classification outcomes of IAS 32;

(b) to improve the information provided through presentation and disclosure of features of financial liabilities and equity instruments not captured by classification alone; and

(c) to improve the consistency, completeness and clarity of the requirements for classification in IAS 32.

BC6 Having considered feedback on the 2018 Discussion Paper, the Board decided not to pursue the proposed classification approach. Instead, the Board decided to explore clarifying the underlying classification principles in IAS 32 to address known practice issues that arise in applying the classification requirements in the Standard. If underlying principles of IAS 32 were impossible to clarify, the Board developed new principles and accompanying application guidance. The Board focused on those practice issues that could be resolved efficiently and effectively without fundamentally changing IAS 32.

BC7 The proposed clarifying amendments are set out in the Exposure Draft *Financial Instruments with Characteristics of Equity*. When developing these proposals, the Board's intention was to limit changes in classification outcomes to cases for which there is enough evidence that the change would provide more useful information to users of financial statements.

BC8 The proposed changes in classification requirements are accompanied by proposed amendments to the presentation requirements in IAS 1 *Presentation of Financial Statements* relating to equity instruments. These amendments would enable entities to provide users of financial statements with more information about amounts—including profit and total comprehensive income—attributable to ordinary shareholders.[1]

BC9 As well as classification and presentation, the Board has further developed some of the disclosure proposals in the 2018 Discussion Paper that were generally supported by stakeholders, in particular, users of financial statements. The development of these proposals reflects feedback on the 2018 Discussion Paper, feedback from additional outreach and other research findings. The Board has also proposed to extend the scope and objectives of IFRS 7 *Financial Instruments: Disclosures* to include information about an entity's equity instruments and proposed additional disclosure requirements linked to its decisions on classification and presentation. The Exposure Draft, therefore, includes proposed amendments to the disclosure requirements in IFRS 7.

1 When issued, [IFRS 18 *General Presentation and Disclosures*] will not include these proposed amendments to IAS 1. When the amendments proposed in the *Financial Instruments with Characteristics of Equity* project are finalised, the Board will consider consequential amendments to [IFRS 18] at that time.

Proposed amendments to IAS 32 *Financial Instruments: Presentation*

BC10 The Board proposes amendments to IAS 32 to clarify:

(a) the effects of relevant laws or regulations (such as statutory or regulatory requirements applicable to a financial instrument) on the classification of financial instruments (paragraphs BC12–BC30);

(b) the ‘fixed-for-fixed’ condition in paragraph 16(b)(ii) of IAS 32 for classifying a derivative that will or may be settled in an issuer’s own equity instruments (paragraphs BC31–BC61);

(c) the requirements in paragraph 23 of IAS 32 for classifying financial instruments containing an obligation for an entity to purchase its own equity instruments (paragraphs BC62–BC93);

(d) the requirements in paragraphs 25 and 28 of IAS 32 for classifying financial instruments with contingent settlement provisions (paragraphs BC94–BC115);

(e) the effect of shareholder discretion on the classification of financial instruments (paragraphs BC116–BC125); and

(f) the circumstances in which a financial instrument would be reclassified as a financial liability or an equity instrument after initial recognition (paragraphs BC126–BC164).

BC11 The Board is not proposing amendments to IAS 32 for the classification of perpetual instruments containing obligations that arise only on liquidation (paragraphs BC165–BC169).

The effects of relevant laws or regulations

BC12 The definitions of a financial instrument, a financial asset, a financial liability and an equity instrument in paragraph 11 of IAS 32 refer to contracts and contractual rights or contractual obligations. Paragraph AG12 of IAS 32 explains that assets or liabilities that are not contractual (such as income taxes created by statute) are not financial assets or financial liabilities. However, questions arise in practice about whether and how relevant laws or regulations (such as statutory or regulatory requirements) affect the classification of an instrument, if:

(a) those laws or regulations create rights and obligations that:

(i) are included in the terms of a contract (for example, when reproduced in the contract); or

(ii) are not explicitly included in the terms of a contract but are implied by law or regulation; and

(b) the enforceability of one or more of the contractual rights and obligations is prevented by a law or regulation.

Relevant laws or regulations that create rights and obligations

BC13 In analysing whether, and if so to what extent, relevant laws or regulations could create rights and obligations that affect the classification of a financial instrument as a financial liability or an equity instrument, the Board considered some examples that are commonly found in practice, including:

(a) financial instruments with ‘bail-in’ provisions, such as Additional Tier 1 capital instruments issued by banks to meet regulatory capital requirements. Many such instruments are perpetual instruments with obligations that arise only on liquidation of the issuer. However, banks are required by law to include a loss-absorption feature in these instruments. That feature might require, for instance, conversion of the instrument into ordinary shares of the issuer, or the write-down of the principal amount, upon the occurrence of a trigger event linked to the capital ratio of the issuer.

(b) ordinary shares with statutory minimum dividends. In some jurisdictions, particular types of entities are required by law to distribute a specified minimum percentage of their profits as dividends to ordinary shareholders.

BC14 An ‘all-inclusive’ classification approach that requires the issuer of a financial instrument to consider contractual terms and rights as well as obligations established by relevant laws or regulations, whether explicitly included in the terms of the contract or implied by laws or regulations, would be consistent with:

(a) paragraph 4.60 of the *Conceptual Framework*, which states that all terms in a contract—whether explicit or implicit—are considered unless they have no substance. Implicit terms include obligations imposed by statute.

(b) other IFRS Accounting Standards that address similar issues. For example, in assessing the existence and enforceability of a right to payment for performance completed to date, paragraph B12 of IFRS 15 *Revenue from Contracts with Customers* requires an entity to consider the contractual terms as well as any legislation or legal precedent that could supplement or override those contractual terms. Similarly, paragraph 2 of IFRS 17 *Insurance Contracts* requires an entity to consider its substantive rights and obligations, whether they arise from a contract, law or regulation. Implied terms in a contract include those imposed by law or regulation.

(c) how contracts are viewed from a legal perspective. Entities applying contract law in many jurisdictions would take into account rights and obligations established by applicable laws, whether explicitly included in the contract or implied by law, in determining the rights and obligations arising from a contract.

BC15 However, applying the approach outlined in paragraph BC14 would go beyond clarifying the classification requirements in IAS 32 (see paragraph BC6). Instead, it would result in a fundamental change to the classification requirements in IAS 32 because such an approach would:

(a) expand the rights and obligations considered when classifying a financial instrument beyond those solely arising from its contractual terms.

(b) blur the line between financial liabilities and other types of liabilities.

(c) be inconsistent with the approach in IFRS 9 *Financial Instruments* for assessing the contractual cash flow characteristics of financial assets. Paragraph B4.1.13 of IFRS 9 provides an example (Instrument E) in which payments that arise only because of a national resolving authority's power to impose losses on instrument holders are not considered when assessing the contractual cash flow characteristics of an instrument because that power, and the resulting payments, are not contractual terms of the instrument.

BC16 Therefore, the Board decided to explore different approaches to clarify when or how laws or regulations are taken into account in classifying a financial instrument as a financial liability or an equity instrument. In assessing the different approaches, the Board was mindful that it is important to users of financial statements that financial instruments with similar economic substance are classified in a consistent way.

BC17 The Board considered but rejected an approach based on the way a right or obligation derived from laws or regulations is reproduced or referred to in a contract. Under this approach, such a right or obligation would be considered in classifying the financial instrument if it would continue to apply throughout the instrument's life despite subsequent changes in laws or regulations. In practice this is commonly referred to as a 'static term' or 'static reference' because the right or obligation remains the same despite future changes in laws or regulations. In contrast, such a right or obligation would not be considered in classifying the financial instrument if it would automatically change when statutory or regulatory requirements change. In practice this is commonly referred to as a 'dynamic term' or 'dynamic reference' because the right or obligation is updated as laws or regulations are changed.

BC18 The Board also considered but rejected an approach that focused on whether rights and obligations derived from laws or regulations are reproduced in a contract. The Board considered that under this approach, two entities based in the same jurisdiction that issue economically similar financial instruments could classify the instruments differently if one entity reproduces the rights and obligations derived from laws or regulations in the contract and the other entity does not. Users of financial statements would expect the instruments to have similar classification because they are subject to the same legal or regulatory requirements and have similar contractual features, irrespective of whether the rights and obligations arising from the laws or regulations are included (or not) in the contract.

BC19 The Board concluded that approaches resulting in classification outcomes that depend on whether and how the rights and obligations arising from laws or regulations are included in the contractual terms—instead of focusing on the nature of the rights and obligations—would not meet the objective of consistent classification for economically similar instruments. In the Board's view, these approaches could also increase the risk of structuring opportunities because a classification outcome would inappropriately be influenced by whether and how entities choose to include rights and obligations arising from laws or regulations in the contractual terms.

BC20 The Board was of the view that, based on the definitions of a financial liability, a financial asset and an equity instrument, it is necessary for the classification of a financial instrument to be based on the contractual terms and conditions of the instrument. However, the Board acknowledged the challenges that arise from the situations described in paragraphs BC17–BC18 and decided to develop an approach that considers only contractual rights and obligations that are in addition to those established by relevant laws or regulations. These contractual rights and obligations are subject to negotiation and agreement between the parties to the contract and, therefore, can be modified by mutual agreement. In contrast, a right or obligation solely created by laws or regulations applies to all similar instruments and cannot be negotiated or modified by the parties to the contract. A change in relevant laws or regulations would affect all instruments subject to those laws or regulations without any action required from the parties to the contract.

BC21 In assessing the appropriateness of such an approach, the Board considered several practical examples of instruments that give rise to the questions described in paragraph BC12, including:

(a) a bail-in instrument involving a contract that references the general bail-in powers of a prudential regulator to require a broad range of actions, including conversion of the instrument into an unspecified number of own shares or shares of another entity. These general bail-in powers can be exercised by the relevant resolution authority in a particular jurisdiction, apply to all issues of similar bail-in instruments in that jurisdiction and are not negotiable between parties to the contract.

(b) an ordinary share for which the relevant laws require an issuer of ordinary shares to pay dividends equalling at least 10% of its profit each year.

BC22 Applying the approach described in paragraph BC20 to these examples, the Board concluded that it would be appropriate for the rights and obligations established by the relevant laws or regulations not to be considered when classifying those instruments because the laws or regulations would exist regardless of whether they are included in the contract. The Board observed that such an approach is also applied by entities in the IFRS 9 classification of an instrument as a financial asset and would be consistent with the example in paragraph B4.1.13 of IFRS 9 (Instrument E) for assessing the contractual cash flow characteristics of financial assets.

BC23 In further developing this approach, the Board considered how the principles would apply when contractual rights or obligations are incremental to a right or obligation established by relevant laws or regulations. For example, the terms of ordinary shares might require the payment of dividends equalling at least 15% of an entity's profit each year, whereas the minimum dividend required by law is 10%. For such instruments, the contractual obligation could be viewed as comprising two elements: the minimum dividend requirement of 10% established by relevant laws and an incremental contractual obligation of 5%.

BC24 Accounting for the obligations separately could provide useful information to users of financial statements and assist them in understanding the incremental obligation established by the contractual terms of the instrument. In the Board's view, this would also result in the minimum obligations arising from relevant laws being accounted for in the same way, irrespective of whether the instrument's terms included any incremental obligation beyond that imposed by law.

BC25 However, separating a contractual obligation and accounting for each element individually might, in some circumstances, be complex and give rise to more questions in practice. For example, if regulations specify a minimum capital ratio that requires the conversion of an instrument into a variable number of ordinary shares, but the contractual terms of the instrument specify a higher threshold, it is not possible to determine the liability that would arise from the regulatory obligation separately from the contractual obligation. The Board was therefore of the view that it would not be practicable to account for the two elements separately. The Board also noted that classifying the entire obligation as a financial liability would result in more comprehensive disclosure of the entity's exposure to liquidity risk and the future cash outflows required to settle the obligation.

BC26 The Board therefore concluded that, in determining the classification of a contractual right or obligation that is in addition to a right or obligation established by relevant laws or regulations, an entity considers such a right or obligation in its entirety.

Relevant laws or regulations prevent enforceability of a contractual right or obligation

BC27 As described in paragraph BC12(b), questions arise in practice about relevant laws or regulations that might prevent the enforceability of a contractual right or obligation included in an instrument's terms and conditions. This situation might occur, for example, if the terms of an instrument state that the instrument is redeemable at the option of the holder but the laws or regulations applying to such an instrument prevent the enforceability of that redemption right.

BC28 Paragraph 13 of IAS 32 states 'contract' and 'contractual' refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. The Board was of the view that if a contractual right or obligation is not enforceable by law, that right or obligation would not be considered when classifying a financial instrument as a financial liability or an equity instrument.

BC29 The Board therefore decided to propose clarifying, in the requirements in draft paragraph 15A of IAS 32, that only contractual rights and obligations enforceable by laws or regulations are considered when classifying a financial instrument as a financial liability or an equity instrument because enforceability by law is implicit in the contractual right or contractual obligation.

BC30 In the Board's view, such a clarification would be consistent with the principle in paragraph 8 of IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* that if redemption of an instrument is unconditionally prohibited by local law, regulation or an entity's governing charter, the instrument is classified as equity.

Settlement in an entity's own equity instruments

BC31 Paragraph 16 of IAS 32 specifies conditions to be met for a financial instrument to be classified as an equity instrument instead of a financial liability, including instruments that will or may be settled in the issuer's own equity instruments. For a derivative to be classified as an equity instrument, paragraph 16(b)(ii) of IAS 32 requires the derivative to be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of the issuer's own equity instruments (sometimes referred to as the 'fixed-for-fixed' condition). Practice questions arise about whether, to meet the fixed-for-fixed condition, variability in the amount of consideration to be exchanged or the number of an entity's own equity instruments is permitted in some circumstances. To address those questions, the Board considered:

(a) the meaning of 'fixed' (paragraphs BC33–BC39);

(b) the effect of foreign currency (paragraphs BC40–BC44); and

(c) which adjustments to the amount of consideration to be exchanged or the number of shares to be delivered, if any, would be consistent with the fixed-for-fixed condition (paragraphs BC45–BC57).

BC32 The Board also considered questions relating to share-for-share exchanges (paragraphs BC58–BC61).

The meaning of 'fixed'

BC33 Many of the practice questions about the application of the fixed-for-fixed condition that arise relate to the meaning of fixed and, more specifically, whether fixed-for-fixed is interpreted as an amount of consideration to be exchanged and a number of shares to be delivered that:

(a) could 'never change'; or

(b) is 'predetermined' in some way.

BC34 In analysing these questions, the Board observed that the rationale for the fixed-for-fixed condition is intended to preclude a financial instrument from being classified as an equity instrument if an entity uses its own equity instruments as currency to settle a contract (see paragraph BC13 of the Basis for Conclusions on IAS 32). Such a contract does not give the instrument holder a residual interest in the entity's assets after deducting all its liabilities and is consistent with the requirements in paragraph 21 of IAS 32, which states that a contract is not an equity instrument solely because it might result in the receipt or delivery of the entity's own equity instruments.

BC35 The Board concluded that to meet the fixed-for-fixed condition, in general, a derivative contract is required to include a fixed exchange ratio—the amount of consideration to be exchanged per equity instrument delivered does not vary. This would be the case, for example, if a derivative contract will be settled by delivering an amount of CU100 in exchange for 20 ordinary shares—in other words, the exchange ratio is fixed at CU5 per share.

BC36 If the exchange ratio is fixed, the amount of cash (or other consideration) to be paid or received in exchange for each of an entity's own equity instruments to be delivered would be fixed in the same way the amount the entity would receive per share would be fixed if it had issued the underlying equity instruments for cash instead (or the amount it would pay per share would be fixed if it had reacquired underlying equity instruments for cash instead). In the Board's view, this situation means the entity's rights and obligations under the derivative are fixed and do not change based on any variables, such as the value of the equity instruments.

BC37 The Board also considered whether the same conclusion applies if a derivative provides one party to the contract with a choice of settlement between two or more classes of the entity's own equity instruments for fixed exchange ratios—for example, if an option holder has the choice of receiving 100 ordinary shares or 125 preference shares in exchange for CU500. In this case, applying the principle described in paragraph BC35, both settlement alternatives would result in classification as an equity instrument because, for each alternative, the exchange ratio is fixed (CU5 per ordinary share and CU4 per preference share, respectively). As a result, the amount of cash the entity would receive in exchange for each class of its own shares that might be delivered on settlement is fixed.

BC38 As part of the analysis, the Board also considered:

(a) the requirement in paragraph 26 of IAS 32, which determines that a derivative that gives one party a choice of settlement is classified as a financial asset or a financial liability unless all the settlement alternatives would result in it being classified as an equity instrument—as is the case in the example in paragraph BC37.

(b) the classification outcome of an economically similar contractual arrangement that consists of two separate instruments: an option to exchange 100 ordinary shares for CU500 and an option to exchange 100 ordinary shares for 125 preference shares. The first option would meet the fixed-for-fixed condition as described in paragraph BC35 and therefore would be classified as an equity instrument. The second option would result in an exchange of a fixed number of one class of the entity's own non-derivative equity instruments for a fixed number of another class of its own non-derivative equity instruments, which is also classified as an equity instrument (see paragraphs BC58–BC61).

BC39 The Board concluded that the fixed-for-fixed condition is met if a derivative provides one party to the contract with a choice of settlement between two or more classes of the entity's own equity instruments if all of the settlement alternatives result in a fixed exchange ratio as described in paragraph BC35.

The effect of foreign currency

BC40 In some cases, a derivative contract is settled by exchanging a fixed amount of foreign currency in exchange for a fixed number of an entity's own equity instruments—for example, a conversion option embedded in a foreign currency convertible bond. If the option is exercised, it would require the exchange of a fixed amount in a foreign currency (being the principal of the bond) for the entity's own equity instruments.

BC41 For such instruments, some stakeholders would regard the amount of consideration to be received on settlement in exchange for each of an entity's own equity instruments as fixed because the amount is fixed in the foreign currency.

BC42 However, for such instruments the amount of cash (or other consideration, such as the settlement of a liability in the case of a foreign currency convertible bond) an entity would exchange on settlement is not fixed in its functional currency, because that amount would vary due to changes in the applicable foreign currency exchange rate. Such an instrument would expose the entity to foreign currency risk and the instrument would not have a fixed exchange ratio.

BC43 The Board proposes clarifying that for the fixed-for-fixed condition to be met, the amount of consideration to be received or paid for each of an entity's own equity instruments is expressed in units of the entity's functional currency. However, such proposed clarification does not change the application of the requirement in paragraph 16(b)(ii) of IAS 32 to foreign currency rights, options and warrants that an entity offers pro rata to all existing owners of the same class of its own non-derivative equity instruments. For such instruments, the currency in which the consideration amount is denominated would not affect their classification.

BC44 The Board also considered the application of the fixed-for-fixed condition in situations in which one entity in a consolidated group issues a derivative over the equity instruments of another entity in the group with a different functional currency. The Board concluded that for such instruments the appropriate reference point would be the functional currency of the entity within the consolidated group whose equity instruments are to be delivered or received on settlement.

Adjustments that are consistent with the fixed-for-fixed condition

BC45 In developing the proposed clarifications in draft paragraphs 22B–22C of IAS 32, the Board acknowledged that many financial instruments that require settlement by delivering an entity's own equity instruments would otherwise meet the fixed-for-fixed condition except that the amount of consideration or number of shares (or both) are subject to contractually specified adjustments. The Board decided to explore whether some types of adjustments could be consistent with the principle for the fixed-for-fixed condition as described in paragraph BC35. In particular, the Board considered:

(a) preservation adjustments; and

(b) passage-of-time adjustments.

Preservation adjustments

BC46 Some derivatives that require an entity to deliver its own equity instruments include what is commonly referred to as 'make-whole' provisions. The purpose of these contractual features is to preserve the economic interests of a future holder of an entity's own equity instruments (future equity instrument holder) relative to a current holder of the entity's own equity instruments (current equity instrument holder). An example would be an entity issuing a warrant over its ordinary shares that includes an adjustment to:

(a) the exercise price of the warrant for dividends that are paid on ordinary shares while the warrant is outstanding; or

(b) the number of shares to be issued on exercise of the warrant if there is a share split or share consolidation while the warrant is outstanding.

BC47 The purpose of these types of adjustments is to ensure current and future equity instrument holders have the same relative residual interest in the net assets of the entity. In other words, a preservation adjustment does not introduce variability to any risks or variables that would not have been present if the entity issued the equity instruments for cash. The Board was therefore of the view that these adjustments could be consistent with the rationale for the fixed-for-fixed condition (see paragraphs BC33–BC39).

BC48 The Board first considered an adjustment that might favour a future equity instrument holder at the expense of current equity instrument holders. This might be the case, for example, when the exercise price of a derivative over own equity instruments is reduced to equal the issue price of newly issued ordinary shares if the issue price (the current market price at the time of issue of the shares) is below the exercise price of the warrant (referred to as a 'down-round' feature). The Board concluded that, if an adjustment to the amount of consideration to be exchanged or the number of shares to be delivered benefits a future equity instrument holder to a greater extent than a current equity instrument holder, such an adjustment is not consistent with the fixed-for-fixed condition.

BC49 The Board also considered the reverse situation, in which an adjustment might favour current equity instrument holders at the expense of a future equity instrument holder. This would be the case, for example, if the exercise price of a warrant over an entity's ordinary shares is adjusted only to compensate the warrant holder for special dividends paid while the warrant is outstanding but not for any annual dividends paid during that period. In such a situation, the warrant holder is partly but not fully compensated for dividends paid while the warrant is outstanding. The Board noted that a derivative that does not contain an adjustment—so provides no compensation to the future equity instrument holder for dividends paid to current equity instrument holders—and meets the fixed-for-fixed condition (as stated in paragraph BC35) would be classified as an equity instrument. Therefore, no minimum level of preservation of the economic interest of the future equity instrument holder is required.

BC50 The Board decided to propose that adjustments that preserve the relative economic interests of a future equity instrument holder to an equal or lesser extent compared to a current equity instrument holder are consistent with the fixed-for-fixed condition.

Passage-of-time adjustments

BC51 A passage-of-time adjustment is an adjustment that compensates either the issuer or the holder of a derivative for changes in the timing of settlement of that derivative resulting from the passage of time. Such adjustments include, for example, the exercise price of an option being adjusted to compensate the option holder for earlier exercise of the option. Passage-of-time adjustments result in variability in the exchange ratio to compensate for variability in the timing of settlement (for example, several possible exercise dates or a range of dates as an exercise period).

BC52 By definition, a derivative is a contract that is settled at a future date. However, unlike other variables that could create uncertainty about the amount of consideration to be received (or paid) or the number of equity instruments to be delivered (or reacquired) on settlement, the passage of time is not uncertain. Therefore, in the Board's view, a passage-of-time adjustment is consistent with the fixed-for-fixed condition.

BC53 The Board considered an example of a derivative over an entity's own shares that specifies, at inception of the contract, a fixed exercise price and a fixed number of shares for each settlement date in a series of future settlement dates that are mutually exclusive (exercise of the derivative on one of the specified dates results in settlement of the derivative). The Board noted that such a contract is economically similar to a series of separate, mutually exclusive derivative contracts that are exercisable at each of the future settlement dates and settled only by an exchange of a fixed amount of consideration for a fixed number of the entity's own equity instruments.

BC54 The Board considered various approaches in determining which passage-of-time adjustments would be consistent with the fixed-for-fixed condition, including requiring:

(a) the amount of consideration to be paid or received for each of an entity's own equity instruments on each possible settlement date to be predetermined at inception of the contract and to vary only with the passage of time. This approach would include determining the amount of consideration to be paid or received for each of the entity's own equity instruments by applying a predetermined formula provided that time is the only variable input into that formula.

(b) the amount of consideration to be paid or received for each of an entity's own equity instruments on each possible settlement date to be predetermined at inception of the contract, to vary only with the passage of time (similar to the approach described in paragraph BC54(a)) and to be 'reasonable'. Determining whether the adjustment is reasonable would require the exercise of judgement. If this approach were applied, the Board would have to develop application guidance to help entities make that judgement.

(c) the amount of consideration to be paid or received for each of an entity's own equity instruments on each possible settlement date to be predetermined at inception of the contract, to vary only with the passage of time (similar to the approach described in paragraph BC54(a)) and to have the effect of fixing on initial recognition the amount of consideration to be paid or received for each of the entity's own equity instruments in terms of a present value. This approach would require the extent of the adjustment to be analysed using a present value calculation to assess whether the difference between the amount of consideration to be paid or received on each settlement date represents only compensation proportional to the passage of time. The present value calculation is not intended to assess whether there is compensation for the time value of money or whether the adjustment is reasonable, and is not related to any effective interest method calculation.

(d) the adjustment to be reasonable. Similar to the approach in paragraph BC54(b), determining whether the adjustment is reasonable would require the exercise of judgement. However, unlike the other approaches, this approach would not require the adjustment to be predetermined at inception of the contract or to vary only with the passage of time. Therefore, this approach would potentially broaden the scope of passage-of-time adjustments that are consistent with the fixed-for-fixed condition, depending on how the Board defined 'reasonable' for this purpose.

BC55 The Board decided not to propose the approaches described in paragraphs BC54(b) or BC54(d) because both approaches would require an entity to exercise judgement to determine if an adjustment is reasonable. The Board was of the view that, even if application guidance were developed to assist entities in making that judgement, it would be difficult to achieve consistent application of the requirements because such an adjustment could be very subjective in practice. Furthermore, the approach in paragraph BC54(d) would extend beyond only permitting adjustments that vary with the passage of time.

BC56 The Board was of the view that the approach in paragraph BC54(c) goes beyond the approach in paragraph BC54(a) because it would ensure the difference in the amount of consideration to be received or paid on each possible settlement date is clearly related to the passage of time (and would therefore limit the risk of structuring opportunities) and be more consistent with the fixed-for-fixed condition. The Board therefore decided to propose the approach in paragraph BC54(c).

BC57 The Board also considered the application of the approach in paragraph BC54(c) to some derivatives on own equity for which the strike price is indexed to a variable such as an interest rate benchmark or an inflation index. In this situation, the strike price is determinable based on a formula specified in the contract; the strike price is not fixed until the date the derivative is settled and all inputs into the formula are known. Paragraph B4.1.7A of IFRS 9 describes interest as consideration for the time value of money, credit risk and other basic lending risks (for example, liquidity risk) and costs (for example, administrative costs) associated with holding the financial asset for a particular period. Interest can also include a profit margin that is consistent with a basic lending arrangement. The analysis of Instrument A in paragraph B4.1.13 of IFRS 9 explains that linking payments of principal and interest on the principal amount outstanding to an unleveraged inflation index resets the time value of money to a current level. The Board concluded that neither type of adjustment would be a passage-of-time adjustment because the strike price per share is not calculated using a predetermined formula that only varies with the passage of time. The inputs vary with an interest rate benchmark or an inflation index.

Share-for-share exchanges

BC58 The Board considered whether a contract that is settled by exchanging a fixed number of one class of the entity's own non-derivative equity instruments for a fixed number of another class of its own non-derivative equity instruments could be classified as an equity instrument. An example is a derivative contract issued by a parent to a non-controlling shareholder of a subsidiary that would be settled by exchanging a fixed number of the subsidiary's shares for a fixed number of the parent's shares. In the group's consolidated financial statements, the contract involves an exchange of a fixed number of one class of own equity instruments for a fixed number of another class of own equity instruments.

BC59 Stakeholders noted that IAS 32 does not address contracts that involve a share-for-share exchange in which both legs of the exchange are a fixed number of own equity instruments. Stakeholders also noted diversity in practice in how entities classify these types of derivative contracts.

BC60 The Board considered that a contract in which both legs of the exchange are a fixed number of own equity instruments would not meet the definition of a financial liability because:

(a) the entity might extinguish one type of own equity with another type of own equity. In effect there will be a transfer within equity to account for the right to receive a fixed number of one class of the entity's own non-derivative equity instruments and the obligation to deliver a fixed number of another class of its own non-derivative equity instruments.

(b) the number of each type of equity instrument to be exchanged is fixed —even though the value of the equity instruments received might differ from the value of the equity instruments delivered—indicating that the entity is not using its own equity instruments as currency. Such an instrument does not give rise to any additional rights or obligations compared to a scenario in which an entity issues and reacquires the underlying equity instruments directly.

BC61 The Board therefore proposes clarifying that a contract that will or may be settled only by the exchange of a fixed number of one class of an entity's own non-derivative equity instruments for a fixed number of another class of its own non-derivative equity instruments is an equity instrument.

Obligations to purchase an entity's own equity instruments

BC62 Paragraph 23 of IAS 32 specifies requirements for contracts containing an obligation for an entity to purchase its own equity instruments. Examples include a forward contract to purchase the entity's own shares or a written put option that gives the option holder the right to require the entity to purchase its own shares. The Board had been asked to clarify:

(a) whether the requirements apply to contracts settled in a variable number of another class of the entity's own equity instruments (paragraphs BC63–BC65);

(b) the reasons for requiring a financial liability for an obligation to purchase own equity instruments to be recognised at the present value of the redemption amount (paragraphs BC66–BC70);

(c) which component of equity is debited on initial recognition of a financial liability when an entity has an obligation to purchase its own equity instruments (paragraphs BC71–BC80);

(d) the initial and subsequent measurement of the financial liability (paragraphs BC81–BC85);

(e) whether gains or losses on remeasurement of the financial liability are recognised in profit or loss (paragraphs BC86–BC89); and

(f) how to account for the expiry of a written put option on the entity's own equity instruments (paragraphs BC90–BC93).

Settlement in another class of an entity's own equity instruments

BC63 Paragraph 23 of IAS 32 refers to contracts that give rise to an obligation for an entity to purchase its own equity instruments, to be settled in cash or another financial asset. However, in some cases, the entity might be required to settle the obligation to purchase its own equity instruments by delivering a variable number of another class of its own equity instruments. For example, a variable number of the parent's shares might be transferred to settle the group's obligation to purchase the subsidiary's shares from holders of non-controlling interests. Stakeholders have questioned whether paragraph 23 of IAS 32 applies to such obligations.

BC64 The Board noted that the definition of a financial liability in paragraph 11 of IAS 32 is not limited to contractual obligations that will be settled in cash or another financial asset. The definition also includes contracts that will or may be settled by delivering a variable number of an entity's own equity instruments. Similarly, paragraph 21 of IAS 32 states that if an entity uses a variable number of own equity instruments to settle a contract, that contract is a financial liability.

BC65 The Board therefore decided to clarify that the requirements in paragraph 23 of IAS 32 also apply to contracts that are settled by delivering a variable number of another class of an entity's own equity instruments.

Recognising obligation to repurchase own equity at present value of redemption amount

BC66 Paragraph 23 of IAS 32 requires that, if a contract contains an obligation for an entity to purchase its own equity instruments, a financial liability is recognised for the present value of the redemption amount by removing the amount from equity. For example, if the entity writes a put option over its own shares that is gross physically settled (consideration is exchanged for own shares), a financial liability is recognised for the present value of the option's exercise price and a corresponding amount is recognised in equity (see paragraphs BC71–BC80). This requirement is commonly referred to as a 'gross presentation' because it requires gross recognition of the financial liability, instead of recognising a net amount based on the difference between the gross amount of consideration payable and the fair value of the shares to be received on settlement or exercise as for other derivatives. If the obligation were or could be net settled (in cash or in shares), derivative accounting would apply.

BC67 Over the years, several questions about the requirements in paragraph 23 of IAS 32 have been submitted to the IFRS Interpretations Committee. In feedback on the 2018 Discussion Paper, some stakeholders continued to ask whether the gross presentation of the financial liability was appropriate. These stakeholders took the view that the requirement was not consistent with the accounting for derivative contracts (which are recognised on a net basis) and results in contracts being presented in the financial statements as if they have already been exercised.

BC68 Paragraphs BC11 and BC12 of the Basis for Conclusions on IAS 32 explain the reasons for the gross presentation requirement, including that:

(a) the requirement is consistent with the treatment of shares that are mandatorily redeemable, thereby resulting in an entity reporting the same information in its financial statements irrespective of whether a redemption clause is embedded in the instrument or in a stand-alone derivative contract;

(b) although payment of the exercise price of a written put option is conditional upon the option being exercised, the entity has an obligation for that amount because it has no control over whether payment is made; and

(c) changing the requirements in paragraph 23 of IAS 32 would involve reconsidering other requirements in IAS 32 that result in liability treatment for obligations conditional on events or choices that are beyond the entity's control.

BC69 The Board decided that reconsidering the gross presentation requirement in paragraph 23 of IAS 32 is beyond the scope of the project (see paragraph BC6). Changing this requirement would create inconsistencies with other requirements in IAS 32 (as noted in paragraphs BC68(c) and BC100).

BC70 The Board remains of the view that recognising a financial liability for the gross amount of consideration payable on settlement helps users of an entity's financial statements assess its exposure to liquidity risk. For example, if a forward contract or written put option over the entity's own shares is settled in cash, the entity's assets would be reduced by the gross amount of that cash outflow because, unlike other derivatives, the entity would receive its own shares on settlement, not assets. There would therefore be a reduction instead of an increase in the net assets of the entity. For these reasons the Board proposes no changes to the requirement to recognise the financial liability at the present value of the redemption amount.

Debit to equity on initial recognition of a financial liability

BC71 If an entity enters into a contract to purchase its own equity instruments, paragraph 23 of IAS 32 requires the entity to recognise a financial liability at the present value of the redemption amount. That amount is removed from equity and included in financial liabilities. However, IAS 32 does not specify the component of equity from which that amount is removed (where to recognise the debit to equity). This situation leads to diversity in reporting, with some entities recognising the debit against non-controlling interest and others recognising it against another component of equity belonging to owners of the parent.

BC72 The Board was also informed that the approach applied on initial recognition has other implications—for example, affecting the accounting for dividends subsequently paid to non-controlling shareholders. Stakeholders have observed diversity in practice in terms of whether to recognise those dividends in profit or loss, or in equity, depending on which component of equity is debited. For example, if the non-controlling interests account is debited, this implies the non-controlling interests have been derecognised and brings into question whether the payment of dividends to non-controlling shareholders still represents a transaction with owners in their capacity as owners. The approach applied on initial recognition also affects the accounting for the expiry or settlement of written put options and forward purchase contracts on own equity instruments.

BC73 The Board considered the requirements in IFRS 10 *Consolidated Financial Statements* in determining how to address the issues relating to non-controlling interests. In particular, IFRS 10 specifies how to assess the effects of potential changes in ownership interests arising from derivative contracts when allocating profit or loss and other changes in equity to non-controlling shareholders and owners of the parent. In general, consolidated financial statements are prepared on the basis of existing ownership interests, as explained in paragraph B89 of IFRS 10.

BC74 Potential ownership interests are taken into account when allocating profit or loss and other changes in equity only if an entity already has access to the returns associated with an ownership interest, as explained in paragraph B90 of IFRS 10. While a non-controlling shareholder retains its rights to the returns associated with an ownership interest, potential ownership interests are not considered when allocating profit or loss or other changes in equity.

BC75 In the case of forward purchase contracts and written put options over an entity’s own equity instruments, non-controlling shareholders usually retain their rights associated with ownership (such as rights to vote and rights to dividends and other distributions) until those contracts are subsequently settled or exercised. For example, eligibility to receive dividends is typically determined based on the recorded owner of shares on a specified date, irrespective of whether ownership of those shares might be subsequently transferred when a forward purchase contract is settled or a written put option is exercised.

BC76 Paragraph B96 of IFRS 10 requires the carrying amount of non-controlling interests to be adjusted if the proportion of equity held by non-controlling interests changes. A change in non-controlling interests occurs only when a forward purchase contract is settled or a written put option is exercised. The Board is therefore of the view that, consistent with IFRS 10, when an entity initially recognises a financial liability for an obligation to purchase own equity instruments in accordance with paragraph 23 of IAS 32, the corresponding amount is debited against the parent’s ownership interests, instead of non-controlling interests, if the entity does not yet have access to the returns associated with ownership of those equity instruments.

BC77 However, some stakeholders said recognising that amount against the parent’s ownership interests would double-count the non-controlling interests subject to the contract. In the view of these stakeholders, the non-controlling interest holders are either entitled to their proportion of the equity held or their right to sell their interest back to the entity, but not both. These stakeholders stated that reducing the carrying amount of non-controlling interests by the forward or written put option would better reflect the economic substance of the transaction.

BC78 The Board did not agree with this feedback and was of the view that requiring recognition of the corresponding debit amount against the parent's ownership interests does not lead to double-counting because:

(a) non-controlling interests represent existing ownership interests that have not yet been extinguished, not potential ownership interests.

(b) granting non-controlling interest holders the right to sell their interest to the entity is an additional right exercisable by the holder and does not replace any of their current rights or ownership interests.

(c) the corresponding amount debited against equity on initial recognition of the financial liability (at the present value of the redemption amount) does not represent the amount by which non-controlling interests will be reduced upon settlement or exercise of the contract. It represents only the initial measurement of the entity's obligation under the contract. The amount debited in equity is not subsequently remeasured.

BC79 The Board considered whether to specify the component of equity against which the corresponding debit amount is recognised. However, the Board observed that there could be jurisdiction-specific restrictions or regulations governing the use of some components of equity. Not specifying the component of equity to be debited would be consistent with the approach in IFRS Accounting Standards with regards to required line items.

BC80 The Board therefore decided that, if an entity does not yet have access to the returns associated with ownership of the equity instruments to be purchased, those equity instruments would continue to be recognised. The initial amount of the financial liability would be removed from a component of equity other than non-controlling interests or issued share capital.

Initial and subsequent measurement of the financial liability

BC81 Paragraph 23 of IAS 32 requires an entity to recognise a financial liability for an obligation to purchase its own equity instruments at the present value of the redemption amount. It also states that, after initial recognition, the financial liability is measured in accordance with IFRS 9. The Board was informed of various practice questions about the initial and subsequent measurement of such a financial liability, for example:

(a) how is the financial liability measured if the amount payable on redemption is variable (such as an instrument puttable at fair value or based on a formula) and subject to a cap?

(b) are different measurement approaches applied to written put options exercisable at fair value, depending on whether they are subject to a cap or without a cap?

(c) what discount rate would be used to calculate the present value of the redemption amount if settlement occurs only after a specified period?

(d) is a financial liability for a written put option subsequently measured using the same approach as on initial recognition or by applying amortised cost or fair value measurement in accordance with IFRS 9?

(e) how is the financial liability measured if there are multiple contingencies that affect the redemption amount?

BC82 The Board noted that, in general, issues relating to the measurement of financial liabilities are outside the scope of the project. Any attempt to resolve the questions in paragraph BC81 would require a major standard-setting project and would significantly delay the completion of this project. Therefore, the Board decided not to propose any fundamental amendments to the measurement requirements in paragraph 23 of IAS 32.

BC83 However, the Board considered that many questions about subsequent measurement could be resolved if an entity applied the same approach for subsequent measurement as that applied for initial measurement (as discussed in paragraphs BC66–BC70). Such an approach would also ensure greater consistency between the assumptions and inputs used for initial and subsequent measurement.

BC84 The Board therefore decided to clarify that, in applying the requirements in paragraph 23 of IAS 32, the probability and estimated timing of exercising an option does not affect the initial or subsequent measurement of the financial liability. The redemption amount is discounted, assuming redemption will occur at the earliest possible redemption date specified in the contract. This clarification is consistent with the 'gross presentation' approach (as discussed in paragraphs BC66–BC70) and the Board's conclusions on similar issues relating to the measurement of financial liabilities arising from financial instruments with contingent settlement provisions (as discussed in paragraphs BC106–BC109).

BC85 The Board also concluded that deleting the reference to IFRS 9 in paragraph 23 of IAS 32 would avoid potential confusion about how an entity measures a financial liability for an obligation to purchase its own equity instruments after initial recognition, given the proposed clarifications discussed in paragraphs BC83–BC84.

Gains and losses on remeasurement of the financial liability

BC86 Paragraph 23 of IAS 32 requires an obligation for an entity to purchase its own equity instruments to be recognised as a financial liability, which requires gains or losses on the remeasurement of the liability to be recognised in profit or loss. However, some stakeholders considered this to be in conflict with the requirements in IFRS 10 to account in equity for transactions with owners in their capacity as owners.

BC87 In the Board's view, there is no such conflict. The Board decided to clarify that such remeasurement gains or losses are recognised in profit or loss, which is consistent with:

(a) paragraph 35 of IAS 32, which requires gains and losses relating to a financial instrument (or component of an instrument) that is a financial liability to be recognised in profit or loss.

(b) paragraph 41 of IAS 32, which requires gains and losses relating to changes in the carrying amount of a financial liability to be recognised in profit or loss, even if they relate to an instrument that includes a right to the residual interest in an entity's assets.

(c) IFRS 9, which generally requires gains or losses on remeasurement of financial liabilities to be recognised in profit or loss.

(d) the Board's conclusions on which component of equity is debited when the financial liability is initially recognised (as discussed in paragraphs BC71–BC80). The debit to the ownership interest of the parent, instead of to non-controlling interests, reflects that the respective ownership interests of the parent and non-controlling shareholders have not yet changed and will not do so until the instrument is settled or exercised. The remeasurement of the financial liability is, therefore, not a transaction with owners in their capacity as owners.

(e) paragraph 106(d)(iii) of IAS 1, which describes transactions with owners in their capacity as owners as contributions by and distributions to owners and changes in ownership interests in subsidiaries that do not result in a loss of control. The remeasurement of a financial liability is not a contribution by or distribution to owners. That remeasurement also does not change the respective ownership interests of the parent and non-controlling shareholders in the subsidiary. Paragraph 109 of IAS 1 specifically mentions reacquisitions of an entity's own equity instruments as a transaction with owners in their capacity as owners. Therefore, only once the instrument is settled or exercised and the entity's own equity instruments are reacquired will this be a transaction with owners in their capacity as owners. The writing of the put option to non-controlling shareholders is not a transaction with owners in their capacity as owners because there has not been a transfer of shares between the parent and the non-controlling shareholders.

BC88 The Board considered examples in IFRS Accounting Standards of transactions with owners in their capacity as owners that involve a right to buy shares. In these examples, the right is granted to *all* existing holders of a particular class of equity instruments. Specifically:

(a) paragraph 16(b)(ii) of IAS 32 describes foreign currency denominated rights issuances, which are offered pro rata to all existing shareholders of the same class, to acquire additional shares. This is a transaction with an entity's owners in their capacity as owners (paragraph BC4I of the Basis for Conclusions on IAS 32).

(b) paragraph 4 of IFRS 2 *Share-based Payment* explains that a transaction with an employee (or other party) in their capacity as a holder of equity instruments of an entity is not a share-based payment transaction. In this transaction, the entity grants all holders of a particular class of equity instruments the right to acquire additional equity instruments at a price that is less than their fair value, and an employee receives such a right because they are a holder of equity instruments of that particular class.

BC89 In the case of the written put options on non-controlling interests, the rights to sell the shares are granted only to a subset of existing holders of a particular class of equity instruments—holders of ordinary shares other than the parent. Therefore, the Board remains of the view that the written put option to non-controlling interest holders is not a transaction with owners in their capacity as owners.

Accounting for the expiry of a written put option

BC90 If a written put option containing an obligation for an entity to purchase its own equity instruments expires without delivery, IAS 32 requires the carrying amount of the financial liability to be removed from financial liabilities and included in equity. However, IAS 32 does not specify the component of equity in which that amount would be included (where to recognise the credit to equity).

BC91 To be consistent with its conclusions on the initial recognition of the financial liability (as discussed in paragraphs BC71–BC80), the Board decided that the amount included in equity when derecognising the financial liability would be recognised in the same component of equity as that from which an amount was removed when initially recognising that financial liability.

BC92 The Board noted that other practice questions relating to the expiry of a written put option would be resolved by its conclusions on the initial recognition of the financial liability. For example, it is not necessary to clarify the measurement of non-controlling interests upon expiry of a written put option over non-controlling interests. Because the amount removed from equity would be recognised in the parent's ownership interest, non-controlling interests would not be affected by the issue of the put option. Non-controlling interests would continue to be recognised and accounted for in accordance with the requirements in IFRS 10 during the life of that put option. Hence, if the put option expires without delivery, an adjustment to non-controlling interests is unnecessary. Similarly, it is unnecessary to clarify the measurement of share capital upon the expiry of other written put options over an entity's own equity instruments. Because the amount removed from equity would be recognised in another component of equity, share capital would not be affected by the issue of the put option. Hence, if the put option expires without delivery, an adjustment to share capital is unnecessary.

BC93 However, the Board decided to clarify the treatment of gains or losses previously recognised in profit or loss from remeasuring a financial liability if it is subsequently derecognised upon expiry of a written put option. Questions arise in practice about whether those gains or losses would be reversed in profit or loss upon expiry of the put option. In the Board's view, those gains or losses would not be reversed in profit or loss. The expiry of the written put option does not change the fact that the original transaction occurred—the put option was issued, giving rise to the financial liability. Any gains or losses previously recognised reflect the remeasurement of that financial liability while it was outstanding. However, an entity could transfer the cumulative amount of those gains or losses from retained earnings to another component of equity.

Contingent settlement provisions

BC94 Paragraph 25 of IAS 32 specifies requirements for classifying financial instruments with contingent settlement provisions, such as an instrument that requires settlement in cash upon the occurrence (or non-occurrence) of an uncertain future event beyond the control of both the issuer and the holder of the instrument. Paragraphs 28–32 of IAS 32 specify requirements for classifying separately the liability and equity components of compound financial instruments. Practice questions arise about:

(a) the order in which entities are required to apply these requirements (paragraphs BC95–BC97);

(b) measurement of the liability component of a compound financial instrument with a contingent settlement provision (paragraphs BC98–BC102);

(c) accounting for discretionary payments relating to a compound financial instrument with a contingent settlement provision (paragraphs BC103–BC105);

(d) the measurement of financial liabilities arising from a financial instrument with a contingent settlement provision (paragraphs BC106–BC109);

(e) the meaning of 'not genuine' in paragraph 25(a) of IAS 32 (paragraphs BC110–BC111); and

(f) the meaning of 'liquidation' in paragraph 25(b) of IAS 32 (paragraphs BC112–BC115).

Order of applying the requirements in IAS 32

BC95 Stakeholders have asked both the IASB and the IFRS Interpretations Committee whether an entity applies the requirements in IAS 32 in any specific order if a compound financial instrument contains a contingent settlement provision, because paragraph 25 of IAS 32 refers to a financial liability but does not refer to a liability component. They noted that if the requirements for contingent settlement provisions were applied before the compound financial instrument requirements, an instrument with a contingent settlement provision would be classified as a financial liability in its entirety, even though it may contain an equity component.

BC96 Paragraph 15 of IAS 32 sets out a general principle for classifying a financial instrument, *or its component parts*, on initial recognition as a financial liability, a financial asset or an equity instrument. The Board also considered that requirements on contingent settlement provisions and compound financial instruments elaborate on and support application of this general principle. The Board is of the view that an entity is required to separate an instrument with a contingent settlement provision that is a compound instrument into its liability and equity components. The entity applies the requirements in paragraph 25 of IAS 32 to identify the liability component of such an instrument. In other words, instead of applying the requirements in paragraph 25 and paragraphs 28–30 of IAS 32 in a particular order, the entity applies both sets of requirements.

BC97 The Board therefore decided to propose amendments to paragraph 25 of IAS 32 to clarify that some financial instruments with contingent settlement provisions may be compound financial instruments with liability and equity components.

Measurement of the liability component of a compound financial instrument with a contingent settlement provision

BC98 Stakeholders also asked how an entity measures the liability component of a compound financial instrument if settlement of that liability component is contingent upon the occurrence (or non-occurrence) of an uncertain future event. More specifically, they asked whether an entity initially measures the liability component at:

(a) the full amount payable to settle the liability component upon occurrence of the uncertain future event discounted from the earliest date that the amount could be required to be paid. This means that the probability of the uncertain future event occurring, or its estimated timing, is not taken into account because the entity does not have an unconditional right to avoid settlement of the liability; or

(b) a probability-weighted amount that takes into account the expected probability of occurrence of the uncertain future event, because whether any payment is required is contingent upon whether an event outside the control of both parties occurs. This means that the estimated timing of the event (and hence settlement of the liability component) will be taken into account, similar to the fair value of a liability without a demand feature.

BC99 The Board noted that the approach in paragraph BC98(a) is consistent with other requirements in IAS 32—for example, paragraph 23 of IAS 32, which requires the obligation to purchase an entity's own equity instruments to be measured at the present value of the redemption amount.

BC100 When developing the requirement in paragraph 23 of IAS 32, the Board rejected an argument that, if an entity has issued a put option over its own equity instruments, the entity should not measure the financial liability arising from that option at the full amount of the exercise price because its obligation to make that payment is conditional upon the option being exercised (see paragraph BC12 of the Basis for Conclusions on IAS 32). The approach in paragraph BC98(a) would result in financial liabilities (or liability components) that could be repayable immediately or at a specified date being measured in the same way, regardless of whether settlement is at the option of the instrument holder or is triggered by an event outside the control of both the issuer and the holder of the instrument. In both cases, settlement is beyond the issuer's control. Therefore, in both cases, the liability would be measured in the same way.

BC101 Applying the approach in paragraph BC98(b) would represent a significant change to IAS 32, which would be beyond the scope of the project (see paragraph BC6). Furthermore, such an approach would require complex calculations, for example, when determining the effective interest rate on initial recognition and when subsequently updating the measurement of the liability component of the compound instrument. An entity would have to reassess the probability and estimated timing of occurrence of the uncertain future event at each reporting date.

BC102 Having considered the matters in paragraphs BC98–BC101, the Board decided to propose amending IAS 32 to require the approach in paragraph BC98(a) for initial and subsequent measurement of the financial liability component. In accordance with this approach, the probability and estimated timing of an uncertain future event occurring does not affect how the liability component of a compound financial instrument with a contingent settlement provision is measured. This clarification would also ensure greater consistency between the assumptions and inputs used for initial and subsequent measurement.

Accounting for discretionary payments

BC103 In some cases, all proceeds from issuing a compound financial instrument may be allocated to the liability component on initial recognition, for example, when an instrument that pays discretionary dividends is redeemable upon the occurrence of an uncertain future event outside the control of both the issuer and holder of the instrument, and that event could occur at any time. On initial recognition of the instrument, the liability component is measured at the full undiscounted amount of the conditional obligation, resulting in the equity component being measured at zero. Stakeholders asked how to account for any discretionary dividends subsequently paid on this type of compound financial instrument.

BC104 Although the equity component of a compound financial instrument might be measured at zero on initial recognition, this is only a measurement requirement; it does not mean the equity component does not exist. Furthermore, an instrument classified as a financial liability in its entirety is different economically from a compound financial instrument with both liability and equity components, even if the equity component is measured at zero on initial recognition. Recognising any discretionary dividends subsequently paid in equity would reflect, and be consistent with, the existence of that equity component.

BC105 The Board also noted that, if some of the proceeds received upon issuance of a compound financial instrument are allocated to the equity component on initial recognition, no question arises about how to account for discretionary dividends subsequently paid—even if the amount allocated to the equity component on initial recognition is very small. In accordance with paragraph AG37 of IAS 32, such discretionary dividends are recognised in equity. The Board concluded that the same treatment should apply in situations in which the equity component is measured at zero on initial recognition and proposes to clarify this treatment. If the Board were to add a requirement for a different accounting treatment of discretionary dividends simply because the equity component of a compound financial instrument was measured at zero on initial recognition, it would draw an arbitrary distinction between two economically similar situations.

Measurement of a financial liability arising from a financial instrument with a contingent settlement provision

BC106 As discussed in paragraph BC102, the Board decided to clarify that, when measuring the liability component of a compound financial instrument with a contingent settlement provision, the probability and estimated timing of that event occurring do not affect the measurement of the liability component. The liability component is measured at the present value of the settlement amount—the settlement amount is discounted based on the assumption that settlement will occur at the earliest possible settlement date specified in the contract.

BC107 The Board noted that clarifying the point raised in BC106 would lead to other questions about how to measure financial liabilities arising from financial instruments with contingent settlement provisions that are not compound financial instruments. Paragraph 25 of IAS 32 does not explain how the financial liability should be measured initially or subsequently. In general, issues relating to the initial and subsequent measurement of financial liabilities are outside the scope of the project. Furthermore, addressing all such measurement issues would significantly delay completion of the project. However, the Board decided to clarify that:

(a) the probability and estimated timing of occurrence of the contingent future event do not affect the initial measurement of the financial liability recognised in accordance with paragraph 25 of IAS 32. The financial liability is measured at the present value of the settlement amount—the settlement amount is discounted based on the assumption that settlement will occur at the earliest possible settlement date specified in the contract.

(b) the measurement approach applied on initial recognition to such liabilities also applies to subsequent measurement of those financial liabilities. This clarification would ensure greater consistency between the assumptions and inputs used for initial and subsequent measurement.

BC108 The clarifications set out in paragraph BC107 would reduce diversity in practice and are consistent with the Board's conclusions on similar issues relating to the initial and subsequent measurement of financial liabilities arising from financial instruments with an obligation for an entity to purchase its own equity instruments (as discussed in paragraphs BC83–BC84). The Board noted that measurement of financial liabilities containing contingent settlement provisions at the full amount of the conditional obligation is mentioned in paragraph BC12 of the Basis for Conclusions on IAS 32 in the context of the Board's discussion on obligations to purchase an entity's own equity instruments.

BC109 The Board considered that a consistent measurement approach is appropriate due to the similarities between financial instruments with contingent settlement provisions and written put options on own shares. For example, financial liabilities are recognised for both of these types of instruments because payment is conditional on an event outside the entity's control. The Board therefore concluded that these financial liabilities are to be measured at the full amount, ignoring the probability and estimated timing of cash flows.

The meaning of 'not genuine'

BC110 In accordance with paragraph 25(a) of IAS 32, if the part of a contingent settlement provision that could require settlement of a financial instrument in cash (or otherwise in such a way that the instrument would be a financial liability) is not genuine, the instrument is classified as an equity instrument. Paragraph AG28 of IAS 32 provides application guidance on the meaning of not genuine and explains that a financial instrument that requires settlement only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur is an equity instrument. Stakeholders have asked how a contractual term is assessed to be 'not genuine', and whether that assessment is based solely on the probability of the contingent event occurring.

BC111 The Board considered that a contingent settlement provision might be included in the contractual terms for genuine commercial, regulatory or tax purposes. A settlement provision based on a contingent event that might be very unlikely to occur could be genuine if the nature of the contingent event is neither extremely rare nor highly abnormal. The Board therefore decided to clarify that determining whether a contractual term is not genuine is not based solely on the likelihood (that is, probability) of an uncertain future event occurring because an entity is required to make judgements in that assessment based on all the specific facts and circumstances (including the terms and conditions of the instrument).

The meaning of 'liquidation'

BC112 In accordance with paragraph 25(b) of IAS 32, a financial instrument that requires settlement in cash (or otherwise in such a way that the instrument would be a financial liability) only in the event of liquidation of the issuer is classified as an equity instrument. According to paragraph BC18 of the Basis for Conclusions on IAS 32, in developing this requirement, the Board concluded that a contingent settlement provision that applies only in the event of liquidation of an entity should not influence classification because to do so would be inconsistent with the going concern assumption. Such a provision is similar to an equity instrument that has priority on liquidation and, therefore, would be ignored when classifying the instrument.

BC113 Stakeholders have asked about the meaning of 'liquidation', including whether this refers only to the end of the process when an entity ceases to exist (for example, by being dissolved) or whether it could be interpreted more broadly to refer to processes such as resolution or administration.

BC114 The Board acknowledged that many terms are used in practice when an entity is a going concern in financial difficulty and when the entity has started the liquidation process. Some events and activities clearly occur before liquidation has begun and have the goal to return the entity to a healthy financial status, whereas other events and activities clearly occur with the goal of winding up the business. For example, in some cases, an entity in financial difficulty might enter into a restructuring process that has the goal of returning the entity to a healthy financial status, instead of ending the business. That process could include laying off employees and selling productive assets in an effort to reduce expenses. Instruments that require settlement in such circumstances would be classified as financial liabilities because the entity is not in the process of liquidation. The Board was of the view that understanding this distinction in the processes would help entities classify financial instruments on initial recognition.

BC115 The Board decided to clarify that the term 'liquidation' refers to the process that begins after an entity has permanently ceased its operations, which is consistent with:

(a) the Board's rationale for developing the requirement in paragraph 25(b) of IAS 32 (as noted in paragraph BC112);

(b) paragraph 4.33 of the *Conceptual Framework*, which equates liquidation with ceasing to trade; and

(c) paragraph 25 of IAS 1, which requires an entity to prepare its financial statements on a going concern basis unless management intends to liquidate the entity or to cease trading or has no realistic alternative but to do so.

Shareholder discretion

BC116 In applying paragraph 19 of IAS 32 to classify a financial instrument (or a component of it) as a financial liability or an equity instrument, an entity considers whether it has an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation. In some cases, settlement occurs at the discretion of the entity's shareholders. For example, the entity issues preference shares that require it to pay coupons subject to ordinary shareholders' approval. Stakeholders have asked, whether, in such situations, the shareholders' decision is treated as the entity's decision and how shareholder decision-making rights affect whether the entity has an unconditional right to avoid settling an instrument in cash (or otherwise in such a way that the instrument would be a financial liability).

BC117 In considering these questions, the Board observed that stakeholders held contrasting views:

(a) some are of the view that shareholders are always seen as part of the entity and, therefore, shareholder decisions are always treated as the entity's decisions.

(b) others are of the view that shareholders are never seen as part of the entity and, therefore, shareholder decisions are never treated as the entity's decisions.

BC118 The Board concluded that applying such an 'all or nothing' approach to all financial instruments would represent a fundamental change to the classification requirements in IAS 32 and would be outside the scope of the project (see paragraph BC6). It would also cause significant disruption to the current application of IAS 32 and would not necessarily provide more useful information to users of financial statements. For example, in some jurisdictions, ordinary shares are issued with terms that allow shareholders to demand the payment of dividends at their discretion. If shareholder decisions are never treated as an entity's decisions, such a view could result in a change in classification for many common instruments from equity to compound financial instruments where the obligations to pay dividends are classified as financial liability components.

BC119 In responding to stakeholder questions, the Board considered developing a principle that could be applied consistently to all financial instruments as part of the classification assessment under IAS 32. In practice, routine decisions made in the ordinary course of an entity's business activities are typically viewed as part of the entity's decisions. The Board considered a proposed principle that shareholder decisions that are routine in nature—those made in the ordinary course of business—are treated as entity decisions. Such routine decisions typically include decisions on recurring items on the entity's annual general meeting agenda, which relate to ordinary year-on-year business matters and usually require approval of a simple majority of shareholders present at the meeting. Conversely, non-routine decisions generally involve special business matters, such as changing the entity's founding documents or approving a change of control of the entity. In many of these non-routine decisions, shareholders might be regarded as making investment decisions—

acting in their capacity as holders of particular financial instruments. These non-routine decisions typically require a higher level of approval (such as 75% of the votes) and might take place at a special meeting outside the annual general meeting.

BC120 However, the Board noted that the approach described in paragraph BC119, which focuses solely on whether a decision is routine in nature, might be too restrictive, in particular if a new type of transaction arises. The assessment of shareholder decision-making rights as either routine or non-routine could also change over time. For example, after shareholder decisions on the same type of transaction have occurred with enough regularity, what was previously regarded as non-routine might become routine. Focusing solely on whether a decision is routine and made as part of the entity's ordinary course of business might fail to address all scenarios that involve shareholder discretion.

BC121 Therefore, instead of focusing solely on one specific factor, the Board decided to propose factors that an entity would be required to consider when assessing whether shareholder decisions are treated as entity decisions. These factors include, but are not limited to whether:

(a) a shareholder decision would be routine in nature—made in the ordinary course of the entity's business activities. As discussed in paragraph BC119, routine decisions that are part of the entity's ordinary course of business are more likely to be treated as entity decisions.

(b) a shareholder decision relates to an action that would be initiated or proposed by the entity's management for approval by shareholders. The Board considered that the role of management (including the board of directors) is to plan and direct the activities of the entity. The Board also considered that the corporate governance framework in many jurisdictions explicitly requires management to act in a fiduciary capacity in the interest of the entity. In some cases, management might be able to avoid an outflow of cash from the entity by not proposing an action requiring shareholder approval. In those cases, shareholder discretion would therefore have no bearing on the classification. The Board expects that routine decisions are likely to be initiated by management. In contrast, the Board considered that if a shareholder decision relates to an action not initiated or proposed by management, such as a non-routine transaction proposed by a third party for shareholder approval, that might suggest the shareholder decision is unlikely to be treated as the entity's decision.

(c) different classes of shareholders would benefit differently from a shareholder decision. The Board considered that a difference in how classes of shareholders benefit from a decision indicates that each class of shareholder would make decisions independently as investors in a particular class of shares, which might suggest that this type of shareholder decision is unlikely to be treated as the entity's decision.

(d) the exercise of a shareholder decision-making right would enable a shareholder to require the entity to redeem (or pay a return on) its shares in cash or another financial asset (or otherwise to settle the obligation in such a way that the instrument would be a financial liability). It is likely that shareholders exercising such rights would make decisions individually as investors in the shares, which might suggest that those shareholder decisions are unlikely to be treated as entity decisions.

BC122 The Board acknowledge that applying such an approach would require an entity to use judgement when considering relevant factors to determine whether a particular shareholder decision would be treated as the entity's decision. Therefore, the factors in paragraph BC121 are not intended to be exhaustive. Furthermore, the Board considered that different weightings would be applied because some factors might be more or less relevant to the assessment depending on the particular facts and circumstances and terms and conditions of the specific contract. Different factors might provide more persuasive evidence in different circumstances. Therefore, the assessment would require a case-by-case analysis for each type of financial instrument issued.

BC123 Some instruments might provide shareholders with more than one right to decide whether an entity settles the instrument in cash or another financial asset (or otherwise in such a way that the instrument would be a financial liability). In the Board's view, each shareholder decision-making right is assessed separately. However, the Board decided that an entity should also consider whether any interdependencies between shareholder decision-making rights would affect whether, overall, the entity has an unconditional right to avoid delivering cash or another financial asset (or otherwise settling a financial instrument in such a way that it would be a financial liability). An example is a financial instrument that pays coupons if the issuer pays dividends on ordinary shares. Management could decide not to propose dividends on ordinary shares and thus avoid paying coupons on the financial instrument. However, the holders of that financial instrument also have the power to force the entity to liquidate, at which point the financial instrument would become repayable in cash at its par value. Assuming no other obligations, the entity is required to have the right to avoid cash settlement in both scenarios for the financial instrument to be classified as equity.

BC124 The Board acknowledged that requiring an entity to exercise judgement based on a non-exhaustive set of factors is subjective. However, the Board concluded that its proposed approach is pragmatic and would help resolve practice questions, by establishing:

(a) an objective for the assessment of shareholder decision-making rights —to assess whether shareholder decisions would be treated as entity decisions in determining whether the entity has an unconditional right to avoid settlement of the instrument in cash or another financial asset (or otherwise in such a way that the instrument would be a financial liability);

(b) relevant factors the entity would have to consider when making that assessment; and

(c) disclosure requirements of judgements made in applying the factors-based approach and in making the assessment of whether a shareholder decision is treated as the entity's decision (see paragraph BC244(a)).

BC125 Furthermore, the Board noted that developing a more prescriptive approach would be difficult and would likely entail a fundamental change to the classification requirements in IAS 32. However, the Board acknowledged that the proposed approach might be considered inconsistent with the approaches taken in other IFRS Accounting Standards. Therefore, to avoid any unintended consequences, the Board decided that the proposed approach cannot be applied by analogy when applying the requirements in other IFRS Accounting Standards to transactions involving shareholders or management.

Reclassification of financial liabilities and equity instruments

BC126 Stakeholders noted that IAS 32 does not contain any general requirements on whether or when the instrument would be reclassified after initial recognition and asked the IASB to clarify:

(a) whether or when reclassifications are required, permitted or prohibited; and

(b) if reclassifications are required or permitted, how to account for those reclassifications.

BC127 More specifically, questions related to whether a change in the substance of a contractual arrangement that occurs without modification to the contractual terms could affect whether the instrument continues to be classified as a financial liability or an equity instrument. To address these questions, the Board considered:

(a) types of changes in the substance of a contractual arrangement (paragraphs BC130–BC134);

(b) reclassification approaches (paragraphs BC135–BC149);

(c) the timing of reclassification (paragraphs BC150–BC156); and

(d) measurement on reclassification (paragraphs BC157–BC164).

BC128 The Board discussed the difference between derecognition and reclassification. IFRS 9 sets out requirements for the derecognition of financial liabilities. IAS 32 sets out requirements for recognising gains or losses on the cancellation of an entity's own equity instruments. Recognition of a new financial instrument following the derecognition of a financial liability or cancellation of an equity instrument is different from a 'reclassification'. In the Board's view, reclassification may be appropriate if a financial instrument continues to exist but there has been a change in the substance of its contractual terms without modification to the contract. The Board therefore concluded that reclassification refers to a change in the classification of an issued financial instrument if:

(a) the requirements for derecognition of a financial instrument are not met;

(b) the entity has not become a party to a new contract to be recognised; and

(c) the nature of the obligation has substantially changed without any modification to the contractual terms.

BC129 The term ‘reclassification’ is sometimes used more broadly to refer to the movement of amounts between financial liabilities and equity. For example, paragraph 23 of IAS 32 requires the carrying amount of a financial liability to be ‘reclassified’ to equity if a contract containing an obligation for an entity to purchase its own equity instruments expires without delivery. In this case, the ‘reclassification’ of an amount from financial liability to equity results from the derecognition of a financial liability on expiry of a financial instrument, not from a change in the instrument’s classification during its life. To avoid any confusion that might arise from using the term ‘reclassification’ in different ways, the Board proposes replacing the two references to ‘reclassified’ in paragraph 23 of IAS 32 with alternative wording.

Types of changes in the substance of a contractual arrangement

BC130 The Board considered that after initial recognition, the substance of a contractual arrangement might change without a modification to its contractual terms when:

(a) contractual terms become, or stop being, effective with the passage of time (paragraphs BC131–BC132); or

(b) a change in circumstances external to the contractual arrangement arises from events not specified in the contract and that have not been considered in classifying the financial instrument on initial recognition (paragraphs BC133–BC134).

BC131 A change resulting from the passage of time (described in paragraph BC130(a)) is specific to the financial instrument and could occur if an instrument contains a contractual term that results in its classification as a financial liability on initial recognition but, at a specified point in the future, that contractual term stops being effective. If the instrument were classified at that point, the instrument would qualify for classification as an equity instrument. For example, an entity issues a warrant that provides the instrument holder with the right to buy a fixed number of the entity’s own equity instruments at a price that will be fixed at a future date. Similar questions also arise about:

(a) contingent consideration in a business combination that an entity will settle by delivering its own equity instruments, if the number of shares to be delivered will be fixed at a future date;

(b) a put option in an instrument that allows the holder to put the instrument to the entity for a fixed amount of cash during a specified period of the instrument's life, if that option expires unexercised at the end of the specified period; and

(c) an instrument classified based on a contingency occurring within a specified period of time, if the contingency does not occur during that period.

BC132 The Board noted that this type of change in substance (as described in paragraph BC130(a)) relates only to instruments that meet the definition of a financial liability on initial recognition. Such a change in substance would not occur if an instrument met the definition of an equity instrument on initial recognition. To meet the definition of an equity instrument, the financial instrument must not contain an obligation to transfer cash or another financial asset (or otherwise to settle the financial instrument in such a way that it would be a financial liability) at any point over the contractual life of the instrument (see paragraph 16 of IAS 32). An instrument containing such an obligation would be classified as a financial liability on initial recognition, unless the requirements for equity classification in paragraphs 16A–16D of IAS 32 are met.

BC133 In the Board's view, a change in circumstances external to the contractual arrangement (as described in paragraph BC130(b)) refers to changes that do not only affect a particular instrument, but also an entity's business activities overall. For example, an entity might issue an instrument that will be settled by the entity delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash denominated in the entity's functional currency. If the entity's functional currency changes, it would not only affect the substance of the contractual arrangement for that specific instrument (the instrument will now be settled in a foreign currency), but would also be evidence of a change in the entity's business operations and activities overall.

BC134 In contrast to the change in substance described in paragraph BC130(a), the change in substance described in paragraph BC130(b) is not limited to instruments that meet the definition of a financial liability on initial recognition. The change in substance described in paragraph BC130(b) could also occur for an instrument that meets the definition of an equity instrument on initial recognition, as illustrated by the example discussed in paragraph BC133.

Reclassification approaches

BC135 The Board considered three approaches to reclassifying a financial instrument as a financial liability or an equity instrument after initial recognition:

(a) generally prohibiting reclassification of the instrument (paragraphs BC136–BC137);

(b) requiring reclassification of the instrument for all changes in the substance of the contractual arrangement (paragraphs BC138–BC139); and

(c) generally prohibiting reclassification of the instrument unless a change in circumstances external to the contractual arrangement occurs (paragraphs BC140–BC143).

Generally prohibit reclassification

BC136 The approach in paragraph BC135(a) is based on a view that the requirements in IAS 32 are intended to generally prohibit subsequent reclassification of a financial instrument. Paragraph 15 of IAS 32 requires classification of the instrument *on initial recognition* in accordance with the substance of the contractual arrangement and the definitions of a financial liability and an equity instrument. The rationale for this approach is that if the International Accounting Standards Committee (IASC), the Board's predecessor body that developed IAS 32, had generally intended a financial instrument to be reclassified after initial recognition, such requirements would have been included in IAS 32 when it was first issued.

BC137 This intention of generally prohibiting reclassification is supported by the requirements in paragraphs 16E–16F of IAS 32 that set out specific requirements that apply to the reclassification of puttable instruments and instruments that impose an obligation on an entity to deliver to another party a pro rata share of the net assets of the entity only on liquidation, if those instruments meet specified criteria. One of the reasons the Board added paragraph 96B of IAS 32, which states that the puttable instruments and obligations arising on liquidation exception cannot be applied by analogy, was to avoid it being used for reclassifications in other cases. If the Board decided to introduce a requirement to generally prohibit reclassification, it would be introduced in a way that does not affect any specific reclassification requirements.

Require reclassification for all changes in the substance of the contractual arrangement

BC138 The approach in paragraph BC135(b) is based on the view that although paragraph 15 of IAS 32 refers to initial recognition of a financial instrument, it requires instruments to be classified in accordance with the substance of the contractual arrangement and the definitions of a financial liability and an equity instrument. If the substance of the contractual arrangement subsequently changes, the instrument would be reclassified. Under this approach, reclassification would be required for both types of change in substance discussed in paragraph BC130. Therefore, reclassification would reflect the substance of the contractual terms that are effective for the remaining life of the financial instruments at the reporting date.

BC139 However, the Board considered that under this approach, an entity would be required to assess at each reporting date, for each financial instrument issued, whether there has been a change in substance that affects whether the instrument meets the definition of a financial liability or an equity instrument at that date. The Board concluded that this approach would require a fundamental change to the current approach in IAS 32 and is, therefore, beyond the scope of this project.

Generally prohibit reclassification unless a change in circumstances external to the contractual arrangement occurs

BC140 The approach in paragraph BC135(c) is similar to the approach in paragraph BC135(a), in that it is based on a view that the IASC generally intended to prohibit reclassification of financial instruments (see paragraph BC136). However, under the approach in paragraph BC135(c), reclassification is appropriate in limited circumstances. Specifically, an instrument would be reclassified if the substance of the contractual arrangement changes due to a change in circumstances external to the contractual arrangement. This approach differentiates the two types of changes in substance discussed in paragraph BC130 as:

(a) changes in substance resulting from a change in circumstances external to the contractual arrangement—reclassification would be required; and

(b) changes in substance when contractual terms become or stop being effective with the passage of time—reclassification would be prohibited.

BC141 This approach builds on the specific reclassification requirements in IAS 32. In particular, paragraph 16E of IAS 32 requires reclassification of particular types of financial instruments (puttable instruments and instruments that impose an obligation on an entity to deliver to another party a pro rata share of the net assets of the entity only on liquidation) in specified circumstances. Those circumstances are similar to the change in substance discussed in paragraphs BC133–BC134—a change in circumstances external to the contractual arrangement. For example, the classification of puttable instruments could change due to the issuance or redemption of financial instruments that are in the most subordinated class but do not have identical features to the puttable instruments. In this situation, a change in circumstances external to the contractual arrangement would affect whether the puttable instruments meet the criteria in paragraphs 16A–16B of IAS 32 for classification as an equity instrument.

BC142 Similarly, this approach would require reclassification of an instrument if a change in circumstances external to the contractual arrangement affects whether the instrument would meet the definition of a financial liability or an equity instrument if classified at that date.

BC143 Reclassification would be prohibited if the substance of the contractual arrangement changes because of a contractual term that becomes, or stops being, effective during the instrument's life, and therefore the instrument would continue to be classified as a financial liability (see paragraph BC132). The entity's financial statements would continue to provide useful information about such instruments. The measurement of the financial liability would be updated to reflect the change in the substance of the contractual arrangement, because such a change would likely affect the nature, timing and amount of the settlement terms. Either the amortised cost would be updated to reflect actual and revised estimated contractual cash flows or the fair value would be updated for such estimates. The proposed disclosure requirements about terms and conditions that become, or stop being, effective with the passage of time would also apply (see paragraph BC219).

The proposed reclassification approach

BC144 The Board noted the merits of the approach in paragraph BC135(b) from a conceptual perspective, specifically that it would:

(a) faithfully represent the substance of the contractual arrangement at each reporting date. Paragraph 2.12 of the *Conceptual Framework* explains that, to be useful, financial information must not only represent relevant phenomena, but it must also faithfully represent the substance of the phenomena it purports to represent.

(b) reflect how the instrument would be classified if it were newly issued at the reporting date with terms similar to the remaining unexpired terms. Hence, entities that issued financial instruments with features similar to the reclassified financial instrument would provide comparable information to users of financial statements.

BC145 However, the Board noted that that approach would increase costs and complexity for preparers of financial statements because entities would have to assess at each reporting date whether an instrument would be reclassified. That classification assessment might be relatively straightforward in the context of a change in circumstances external to the contractual arrangement (such as a change in functional currency or a change of control of a subsidiary), particularly because such changes do not occur frequently. On the other hand, contractual terms that become, or stop being, effective with the passage of time are common in derivative contracts on own equity instruments and in convertible bonds. Such instruments would require various contractual terms to be monitored or tracked in each reporting period, which could be onerous for preparers.

BC146 Furthermore, in the Board's view, introducing a requirement to reclassify an instrument as a financial liability or an equity instrument for all types of changes in the substance of the contractual arrangement would go beyond clarifying the requirements in IAS 32. For the reasons described in this paragraph and paragraph BC145, the Board concluded it would not propose the approach in paragraph BC135(b).

BC147 The Board also concluded that it would not propose the approach in paragraph BC135(a) because it would not improve the information provided to users of financial statements about financial instruments issued by an entity.

BC148 Instead, the Board decided to propose the approach in paragraph BC135(c), which provides an appropriate balance between the benefits to users of financial statements and the costs to preparers, as well as taking into account the project's scope. For example, the approach in paragraph BC135(c):

(a) would require an entity to reclassify an instrument if the substance of a contractual arrangement changed due to a change in circumstances external to the contractual arrangement. Therefore, this approach has some of the conceptual advantages of the approach in paragraph BC135(b) and would provide more useful information to users of financial statements in these situations compared with the approach in paragraph BC135(a).

(b) reduces the risk of opportunistic classifications from structuring the terms of the contract to achieve a particular classification outcome.

(c) is not expected to be overly onerous for preparers to apply because reclassification would be required in limited situations only.

(d) although it could be viewed as introducing a significant change to IAS 32, would be less significant than the approach in paragraph BC135(b).

BC149 The Board also noted that the approach in paragraph BC135(c) is consistent with the approach used in IFRS 9 for reclassifying financial assets when there is a change in the business model for managing financial assets. IFRS 9 has a 'mixed model' of reclassification—it prohibits the reclassification of financial assets if the contractual cash flow characteristics change (similar to passage-of-time changes discussed in paragraph BC130(a)), but requires reclassification if the business model changes because of changes outside of the contract (similar to changes described in paragraph BC130(b)).

Timing of reclassification

BC150 The Board considered the date on which a financial instrument would be reclassified as a financial liability or an equity instrument. The Board considered reclassification at:

(a) the beginning of the first reporting period following the period in which the change in circumstances occurs (paragraphs BC151–BC152);

(b) the end of the reporting period in which the change in circumstances occurs (paragraph BC153);

(c) the date of change in circumstances (paragraphs BC154 and BC156); or

(d) the date of change in circumstances, if that date is determinable, or if not, at the end of the reporting period (paragraph BC155).

BC151 The first approach (described in paragraph BC150(a)) would be consistent with the approach applied in IFRS 9 for reclassifying financial assets for measurement purposes. This approach would also be simple for entities to apply. For example, it would avoid the consequences on recognition and measurement of reclassifying a financial instrument during the reporting period (such as calculating interest expense for a partial period) and any possible practical difficulties in determining the date of change in circumstances.

BC152 However, the Board considered that this approach depends on the frequency of reporting and would mean an entity's statement of financial position at the end of the reporting period in which a change in circumstances has occurred would not faithfully represent the substance of the contractual arrangement at that reporting date. Reclassifying financial instruments as either financial liabilities or equity instruments substantially affects the structure of an entity's statement of financial position and, therefore, the understandability of the financial statements as a whole. It also affects calculations such as net debt and other ratios based on an entity's financial liabilities and equity. The Board therefore decided not to propose the approach in paragraph BC150(a).

BC153 The other three approaches (paragraphs BC150(b)–(d)) would all result in an entity's statement of financial position faithfully representing the substance of the contractual arrangement at the reporting date. In comparing those approaches, the Board noted that reclassification at the end of the reporting period would be the simplest and least costly for entities to apply. For example, it would avoid the recognition and measurement consequences of reclassifying a financial instrument during the reporting period (such as calculating interest expense for a partial period) and any possible practical difficulties in determining the date of change in circumstances. However, if such an approach were applied, the timing of reclassification would depend on the reporting frequency. Furthermore, such an approach would be inconsistent with the specific reclassification requirements in IAS 32, which apply to puttable financial instruments and instruments that impose an obligation on the entity to deliver to another party a pro rata share of the net assets of the entity only on liquidation, if those instruments meet specified criteria. Paragraphs 16E–16F of IAS 32 require such an instrument to be reclassified from the date when the instrument meets (or ceases to meet) the specified criteria for classification as an equity instrument. The Board therefore decided not to propose the approach in paragraph BC150(b).

BC154 The Board considered whether any practical considerations would arise if it were to introduce a requirement for the reclassification of a financial instrument as a financial liability or an equity instrument at the date when a change in circumstances occurs. For example, the Board considered whether determining the date of change in circumstances would be difficult in some instances. Research conducted during the project indicates that the most common situations involving a change in circumstances that would result in reclassification are changes in the entity's functional currency or group structure that affect the classification of derivatives when applying the fixed-for-fixed condition in paragraph 16(b)(ii) of IAS 32.[2] In both cases, although determining the date of change in circumstances might not be straightforward, the entity would have to determine that date to comply with other applicable IFRS Accounting Standards. Paragraph 35 of IAS 21 *The Effects of Changes in Foreign Exchange Rates* requires an entity to account for a change in its functional currency from the date of that change. Similarly, paragraph 20 of IFRS 10 requires an entity to consolidate (or cease to consolidate) a subsidiary from the date it obtains (or loses) control of that subsidiary.

2 See paragraphs BC31–BC61 for a discussion of the fixed-for-fixed condition.

Therefore, the date the entity determines in its application of IAS 21 or IFRS 10 could also be used by the entity for reclassifying a financial instrument whose classification is affected by that change in circumstances.

BC155 The Board discussed but rejected the approach in paragraph BC150(d) requiring reclassification at the date of the change in circumstances if that date is determinable, or, if not, at the end of the reporting period. Applying that approach, reclassification at the end of the reporting period would be expressed as a 'backstop' if an entity could not determine the date of the change in circumstances. Allowing a 'backstop' would be too subjective and it would be difficult to achieve consistent application in practice using such an approach.

BC156 Therefore, the Board proposes the approach in paragraph BC150(c), requiring an entity to reclassify a financial instrument as a financial liability or an equity instrument from the date of the change in circumstances that affects the classification of that instrument. This approach ensures users of financial statements receive information that faithfully represents the substance of the contractual arrangement throughout the reporting period, including at the reporting date. The approach is also consistent with the requirements in paragraph 16F of IAS 32.

Measurement on reclassification

BC157 If a financial instrument is reclassified, questions arise about whether an entity would remeasure the instrument to its fair value at the date of reclassification and recognise any gain or loss in profit or loss. The Board considered:

(a) an equity instrument reclassified as a financial liability (paragraphs BC158–BC160); and

(b) a financial liability reclassified as an equity instrument (paragraphs BC161–BC164).

An equity instrument reclassified as a financial liability

BC158 If a financial instrument classified as an equity instrument is reclassified as a financial liability, that reclassification is treated in practice as being similar to:

(a) the cancellation of an equity instrument, with no gain or loss recognised in profit or loss as required by paragraph 33 of IAS 32; and

(b) the initial recognition of a financial liability at its fair value as required by IFRS 9.

BC159 Although reclassifying an equity instrument as a financial liability is not the same as cancelling an equity instrument or issuing a new instrument classified as a financial liability, the approach applied in practice is consistent with the requirements in paragraph 16F(a) of IAS 32. That paragraph applies if specific types of financial instruments (such as puttable instruments) are reclassified from equity instruments to financial liabilities. It requires:

(a) measuring the financial liability at its fair value at the date of reclassification; and

(b) recognising any difference between the fair value of the financial liability and the carrying amount of the equity instrument at the date of reclassification in equity, consistent with the original classification in equity.

BC160 The Board therefore concluded that if an equity instrument is reclassified as a financial liability, an entity would measure the financial liability at its fair value at the date of reclassification. Any difference between the carrying amount of the equity instrument and the fair value of the financial liability at the date of reclassification would be recognised in equity.

A financial liability reclassified as an equity instrument

BC161 Stakeholders observed that when a financial instrument classified as a financial liability is reclassified as an equity instrument, there is diversity in practice. In particular:

(a) some entities follow the requirements in paragraph AG32 of IAS 32, which address the conversion of a convertible instrument on maturity. These entities do not remeasure the financial instrument at its fair value at the date of reclassification. Instead, the carrying amount of the financial liability is moved to equity, with no gain or loss recognised in profit or loss.

(b) other entities follow the requirements in IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments*, which address transactions that are sometimes referred to as 'debt for equity swaps'. These entities remeasure the financial instrument at its fair value at the date of reclassification and recognise any difference between that fair value and the carrying amount of the financial liability as a gain or loss in profit or loss.

BC162 The approach described in paragraph BC161(a) is consistent with the requirements in paragraph 16F(b) of IAS 32, which applies when specific types of financial instruments (such as puttable instruments) are reclassified from financial liabilities to equity instruments. Paragraph 16F(b) of IAS 32 requires the equity instrument to be measured at the carrying amount of the financial liability at the date of the reclassification. As a result, no gain or loss is recognised on reclassification of the instrument.

BC163 The approach described in paragraph BC161(b) reflects accounting that applies if the terms of a financial liability are renegotiated and result in the entity issuing equity instruments to a creditor to extinguish all or part of the financial liability. Those transactions involve derecognising the original financial instrument (or part of it) and recognising a newly issued financial instrument, instead of reclassifying the instrument.

BC164 The Board therefore concluded that if a financial liability is reclassified as an equity instrument, an entity would measure that equity instrument at the carrying amount of the financial liability at the date of reclassification, with no gain or loss recognised on reclassification.

Obligations that arise only on liquidation (perpetual instruments)

BC165 The Board discussed the classification of perpetual instruments containing obligations that arise only on liquidation. In accordance with IAS 32, entities classify these instruments as equity instruments although they have many 'debt-like characteristics'. If the classification approach proposed in the 2018 Discussion Paper had been introduced in IAS 32, it would have resulted in these instruments being classified as financial liabilities, at least in part. Many respondents to the 2018 Discussion Paper were opposed to that change.

BC166 These types of perpetual instruments have features that are typical of financial liabilities as well as features that are typical of equity instruments. Feedback from investors indicated that if an entity is not in financial difficulty these types of instruments behave like financial liabilities, but if the entity is in financial difficulty they behave like equity instruments. For example, a financial instrument with no fixed maturity may have fixed rate coupons payable on specified dates, but the issuer has the right to defer or cancel the coupons and defer repayment of the principal amount indefinitely until the issuer's liquidation. The instrument is subordinated to all other issued instruments (except ordinary shares) in terms of liquidation priority.

BC167 Research conducted during the project shows that the market for these types of financial instruments has grown significantly since their inception, both for Additional Tier 1 capital instruments issued by banks and for hybrid instruments issued by corporates.

BC168 The Board conducted further research and stakeholder outreach before deciding on the classification of these types of instruments. The outreach specifically targeted equity investors who invest in entities' ordinary shares. The objective was to understand whether classifying these types of instruments as financial liabilities would serve their information needs better than classifying them as equity instruments. Most of the equity investors expressed a preference for these types of instruments to be classified as financial liabilities, but they acknowledged that these types of instruments are different from other financial liabilities and have features similar to other equity instruments. As a compromise, the investors said, if equity classification is retained, clear presentation in the financial statements accompanied by additional disclosures would be required to meet their information needs. In particular, the investors said they require transparency about whether an entity has issued these types of instruments and the amount of coupons the entity pays on the instruments issued.

BC169 Considering both investor feedback and the costs and benefits of a classification change, the Board concluded that it would not change the classification outcomes of these perpetual instruments. Instead, the Board considered how best to meet investor information needs when it developed presentation requirements (paragraphs BC246–BC256) and disclosure requirements (paragraphs BC191–BC241).

Proposed amendments to IFRS 7 *Financial Instruments: Disclosures*

Objective

BC170 The feedback on the 2018 Discussion Paper indicated general support for the proposed disclosure requirements in IFRS 7, including those about the terms and conditions of financial liabilities and equity instruments issued by an entity. Stakeholders acknowledged that it was often difficult to understand which features led to the classification of a financial instrument as a financial liability or an equity instrument. They welcomed the proposed disclosures in the 2018 Discussion Paper, anticipating that these disclosures would improve the transparency and understandability of financial instruments.

BC171 IFRS 7 does not include any specific disclosure requirements about equity instruments or equity components of compound instruments that are in the scope of IAS 32. In accordance with IAS 32, equity instruments are not remeasured and therefore the disclosure objectives in IFRS 7 would not be applicable to equity instruments because they do not expose the issuer to balance sheet risk and income statement risk as noted in paragraph BC8 of the Basis for Conclusions on IFRS 7.

BC172 In response to feedback, the Board developed the disclosure requirements in IFRS 7 proposed in this Exposure Draft, which would apply to an entity's financial liabilities and equity instruments. Expanding the scope of the proposals to require disclosures about equity instruments is intended to provide useful information to users of financial statements—helping them understand how the entity is financed, its ownership structure and the potential dilution to its ownership structure from financial instruments that are issued at the reporting date. The Board therefore proposes to amend the objectives of IFRS 7 accordingly.

Scope

BC173 Paragraph 3 of IFRS 7 requires the Standard to be applied by all entities to all types of financial instruments except for those that are specifically excluded from the scope. Paragraph 11 of IAS 32 defines a financial instrument as any contract that gives rise to a financial asset of one entity and a financial liability or an equity instrument of another entity. Therefore, paragraph 3 of IFRS 7 includes equity instruments within the scope of this Standard.

BC174 Paragraph 3(a) of IFRS 7 specifically excludes derivatives linked to interests in subsidiaries, associates or joint ventures from the scope of IFRS 7 if the derivative meets the definition of an equity instrument. As discussed in paragraph BC171, paragraph BC8 of the Basis for Conclusions on IFRS 7 explains that this exclusion is based on the objectives in IFRS 7. If the objectives in IFRS 7 are amended, as discussed in BC172, such an exclusion would no longer be required. The Board proposes to amend paragraph 3(a) of IFRS 7 so that derivatives linked to interests in subsidiaries, associates or joint ventures that meet the definition of equity instruments are no longer excluded from the scope of the Standard.

BC175 Paragraph 3(e) of IFRS 7 specifically excludes financial instruments, contracts and obligations under share-based payment transactions to which IFRS 2 applies. When developing the proposed disclosure requirements relating to the potential dilution of ordinary shares, the Board concluded that maximum dilution should include dilution from share-based payment transactions in the scope of IFRS 2 that are or may be settled in an entity's ordinary shares. Therefore, the Board proposes to amend paragraph 3(e) of IFRS 7 so that share-based payment transactions are subject to the proposed maximum dilution disclosure requirements.

BC176 Paragraph 80A of IAS 1 specifies disclosure requirements relating to the reclassification of financial instruments that are required to be classified as equity instruments in accordance with paragraphs 16A–16D of IAS 32, and paragraph 136A of IAS 1 specifies disclosure requirements for puttable instruments classified as equity in accordance with paragraphs 16A and 16B of IAS 32. Therefore, the Board proposes to move paragraphs 80A and 136A of IAS 1 to IFRS 7, subject to editorial changes and amend the scope of IFRS 7 accordingly. The Board concluded that it would be better to locate disclosure requirements specific to a type of financial instrument in an IFRS Standard dealing with disclosures of financial instruments than in a general presentation and disclosure standard such as IAS 1.[3]

Significance of financial instruments for financial position and performance

Statement of financial position

Reclassification

BC177 The Board proposes to add general requirements in IAS 32 to prohibit reclassification unless the substance of the contractual arrangement changes due to a change in circumstances external to the contractual arrangement. This proposal would not affect reclassifications already required in IAS 32, for example specific reclassification requirements on puttable instruments and obligations to deliver a pro rata share of the net assets of the entity only on liquidation.

3 The disclosure requirements in paragraphs 80A and 136A of IAS 1 *Presentation of Financial Statements* have been relocated to draft paragraphs 12E and 30I of IFRS 7, respectively, subject to editorial changes. [IFRS 18 *General Presentation and Disclosures*] will include the same proposed amendments.

BC178 The Board also acknowledged the importance of disclosures in helping users of financial statements improve their understanding of the reasons for reclassifications and their effect, if any, on measurement. Therefore, the Board decided to relocate the disclosure requirement in paragraph 80A of IAS 1 for reclassifying puttable instruments and obligations to deliver a pro rata share of the net assets of the entity only on liquidation to IFRS 7. It also decided to expand paragraph 80A to cover reclassifications if there are changes in the substance of the contractual arrangement from a change in circumstances external to the contractual arrangement. Entities would be required to disclose the amounts reclassified into and out of financial liabilities or equity, and the timing and reason for that reclassification.

Compound financial instruments

BC179 While discussing the proposed requirements relating to the disclosure of terms and conditions of a financial instrument that led to its classification, the Board also decided to propose that the terms and conditions that determine an instrument's classification on initial recognition as a compound financial instrument with separate liability and equity components shall be disclosed.

BC180 For compound financial instruments, such as mandatory convertible bonds with fixed coupons, the Board proposes requiring disclosure of the amounts initially allocated to the liability and equity components in the reporting period in which the financial instrument is initially recognised. This information would be useful to users of financial statements because, after separation, it is not always clear that the components were part of a compound instrument.

Statement of comprehensive income

Items of income, expense, gains or losses

BC181 The Board discussed concerns regarding a subset of financial liabilities that are subsequently measured at fair value through profit or loss in accordance with IFRS 9. Stakeholders questioned the recognition of changes in the carrying amount of the financial liability in profit or loss if the financial liability includes a contractual obligation to pay the holder an amount that varies with the issuing entity's performance or changes in its net assets. Stakeholders commented that fair value gains are recognised if an entity underperforms and fair value losses are recognised when an entity performs well. The Board considered that recognising those changes in other comprehensive income would represent a fundamental change to the requirements in IAS 32 which is outside the scope of the *Financial Instruments with Characteristics of Equity* project.

BC182 The Board decided not to make any changes to the presentation requirements because there were mixed views among the respondents to the 2018 Discussion Paper for separate presentation in either the statement of financial position or the statement of comprehensive income. Furthermore, the Board considered that the principles and requirements in IAS 1 provide (and the requirements that would apply following the finalisation of the IASB's

Primary Financial Statements project would provide) an adequate basis for entities to determine whether to present particular types of financial liabilities and their associated gains or losses separately in their primary financial statements. Another reason for this decision was that a financial liability that includes a contractual obligation to pay an amount that varies with the issuing entity's performance or changes in its net assets is an example of a financial liability with 'equity-like characteristics' (see proposals included in draft paragraphs B5E–B5F of IFRS 7) and would be in the scope of the disclosure proposals on terms and conditions (see proposals included in draft paragraph 30D of IFRS 7). The 2018 Discussion Paper referred to examples such as shares redeemable at fair value and equity-indexed interest or principal payments embedded in a host debt instrument for these types of financial liabilities.

BC183 The Board concluded that such financial liabilities would generally be measured at fair value through profit or loss, because the financial liability would typically be:

(a) a stand-alone derivative financial liability;

(b) an embedded derivative not closely related to a host financial liability and is separated; or

(c) a hybrid contract designated at fair value through profit or loss in its entirety because the contract contains one or more embedded derivatives that would otherwise have to be separated.

BC184 In the Board's view, if any of these instruments are measured at amortised cost, the proposed disclosure requirements in the 2023 Exposure Draft: *Amendments to the Classification and Measurement of Financial Instruments* (see paragraphs 20B and 20C of proposed amendments to IFRS 7 in that Exposure Draft) would provide the information users of financial statements need. Therefore, the additional disclosure requirements proposed in this Exposure Draft relate to financial liabilities that include a contractual obligation to pay amounts based on an entity's performance or changes in its net assets and are either mandatorily measured or designated at fair value through profit or loss.

BC185 In accordance with paragraph 20(a)(i) of IFRS 7, an entity presents or discloses separately the net gain or loss on financial liabilities designated at fair value through profit or loss from the net gain or loss on financial liabilities mandatorily measured at fair value through profit or loss (for example financial liabilities that meet the definition of 'held for trading' in IFRS 9). For financial liabilities designated at fair value through profit or loss, an entity discloses separately the amount of gain or loss presented in other comprehensive income relating to 'own credit risk' from the amount recognised in profit or loss.

BC186 The Board proposes further disaggregating financial liabilities designated at fair value through profit or loss and mandatorily measured at fair value through profit or loss. Under these proposals, for financial liabilities that include contractual obligations to pay amounts based on an issuing entity's performance or changes in its net assets, the entity is required to disclose the gains or losses recognised on these financial liabilities in each reporting period separately from the gains or losses on other financial liabilities. In the Board's view, this information would help users of financial statements understand the impact on profit or loss of changes relating to the issuing entity's performance or changes in its net assets. It would also help distinguish these gains or losses from income and expenses arising from other types of financial liabilities. The Board concluded that, together with the proposed disclosures on 'debt-like and equity-like characteristics' discussed in draft paragraphs 30D and B5E–B5F of IFRS 7, these disclosures are expected to provide more useful information to the users of financial statements.

BC187 However, some Board members questioned how the proposed disclosure requirements would relate to requirements in paragraph 41 of IAS 32, observing that the proposed requirements would appear to be a duplication of the requirements.

BC188 The Board observed that the second sentence in paragraph 41 of IAS 32 refers to the requirement in paragraph 85 of IAS 1, which requires presentation of additional line items, headings and subtotals in the statement(s) presenting profit or loss and other comprehensive income if this information is relevant to understanding an entity's financial performance.

BC189 The Board concluded that the scope of the proposed disclosure requirements is different from the scope of paragraph 41 of IAS 32. The proposed disclosure relates to changes in the fair value measurement of financial liabilities that include contractual obligations to pay amounts that vary with the issuing entity's performance or changes in its net assets. Paragraph 41 of IAS 32 relates to a broader population, because it refers to gains and losses from changes in the carrying amount of financial liabilities even if the instrument gives the holder a right to the residual interest in the entity's assets. For example, it applies to financial liabilities subsequently measured at amortised cost, financial liabilities that include obligations that do not vary with the issuing entity's performance and financial liabilities that do not include a holder's right to the residual interest in the assets of the entity. Therefore, the proposed disclosure requirement is not a duplication of the requirement in paragraph 41 of IAS 32. Nonetheless, the Board proposes to delete the second sentence of that paragraph to avoid any perceived duplication of requirements.

Other disclosures

BC190 The 2018 Discussion Paper proposed enhancing disclosure requirements for financial instruments issued by an entity. Stakeholders, particularly users of financial statements, generally agreed with these proposals. The Board has refined these proposals, taking into account feedback on the Discussion Paper, feedback from additional outreach activities and other research findings. The Board also proposes additional disclosure requirements based on its deliberations on the classification and presentation topics, relating to:

(a) the nature and priority of claims on liquidation, arising from financial instruments (paragraphs BC191–BC201);

(b) the terms and conditions of financial instruments (paragraphs BC202–BC219);

(c) the potential dilution of ordinary shares (paragraphs BC220–BC241); and

(d) financial instruments that include an obligation for an entity to purchase its own equity instruments (paragraph BC243).

Nature and priority of claims on liquidation, arising from financial instruments

BC191 Entities issue either debt or equity instruments or a combination of both when raising funds to finance their business activities and acquire their assets. The Board considered that, historically, understanding an entity's debt-to-equity ratio was a core part of analysing how the entity had been financed. However, many entities are now financed by complex financial instruments that combine characteristics of financial liabilities and equity instruments and have different levels of subordination.

BC192 This financial innovation has led to new ways of distributing risks and returns between different types of instrument holders. Users of financial statements requested more information to help them assess the nature of these claims against the entity and understand how the claims affect the entity's liquidity and solvency. The feedback highlighted a general need for better and more transparent information about an entity's financing structure.

BC193 To address the general need for better and more transparent information about an entity's financing structure, the Board considered:

(a) the scope of the proposed disclosure requirements (paragraphs BC194–BC196); and

(b) what information is required to be disclosed (paragraphs BC197–BC201).

Scope of proposed disclosure requirements

BC194 The Board considered that IFRS Accounting Standards do not define 'financing structure', 'capital structure' or 'capital'. For example, IAS 1 requires the disclosure of information to help users of financial statements evaluate an entity's objectives, policies and processes for managing capital, but does not define what 'capital' means. Instead, paragraphs 134–136 of IAS 1 require information to be disclosed based on what an entity manages as capital.

BC195 The Board was of the view that developing a definition of 'capital structure' might be problematic and unhelpful. For example, the term 'capital structure' is generally used to refer to the particular combination of debt and equity used by an entity as long-term financing of its overall business activities. However, it might be unclear whether particular types of finance are long-term or short-term. Introducing a threshold—such as funding sources not repayable within 12 months of the reporting date—might not adequately capture all funding sources that are part of the entity's capital structure. For example, some instruments repayable upon demand or within 12 months might be important or recurring sources of funding.

BC196 Instead of developing a definition of 'capital structure', the Board proposes that these disclosure requirements apply to all financial liabilities and equity instruments within the scope of IAS 32. This approach would be simple for entities to apply and would help ensure the information provided is complete and comparable across reporting periods and between entities with similar types of instruments.

What information is required to be disclosed

BC197 The Board considered that, for users of financial statements to understand the nature of any claims against an entity's assets and how those claims affect the entity's liquidity and solvency, this would require an entity to disclose disaggregated information about different classes of claims against the entity.

BC198 The Board also considered that the appropriate level of disaggregation would differ between different types of entities, or even between similar entities, depending on the nature, type and complexity of financial instruments issued. For example, for banks and other financial institutions, categorising claims based on loss-absorbing capacity might be consistent with how information is reported for regulatory purposes and result in more useful information being provided to users of financial statements, while also minimising the cost of preparing the information. However, additional categories to those used for regulatory purposes might be required to capture all relevant features of and all claims against an entity in the scope of IAS 32.

BC199 The Board was therefore of the view that the appropriate level of disaggregation would depend on the factors that determine and influence the nature and priority of claims against the entity, for example subordination, collateralisation, and loss-absorbing capacity. The Board concluded that an entity would need to apply judgement when deciding how to categorise claims for the purposes of the disclosure. However, to ensure some level of comparability and meet the needs of users of financial statements, the Board decided to propose that, at a minimum, an entity disaggregates claims based on their collateralisation, their contractual subordination and, in the consolidated financial statements, also based on whether they were issued by the parent or by subsidiaries. Specifically:

(a) in an entity's separate and consolidated financial statements, the entity shall distinguish between:

  (i) secured and unsecured financial instruments; and

  (ii) contractually subordinated and unsubordinated financial instruments; and

(b) in consolidated financial statements, the entity shall distinguish between:

  (i) financial instruments issued by the parent; and

(ii) those issued by subsidiaries (including amounts of non-controlling interests).

BC200 In considering stakeholders' concerns about the burden on preparers and the volume of information that complex groups of entities might have to disclose, the Board decided that for the purposes of the consolidated financial statements, the information described in BC199 would not require the group to disclose the relative ranking of individual financial instruments at an individual entity level or to assume a scenario in which an entire group is liquidated. Instead, claims are based on the contractual characteristics of financial instruments, irrespective of which member of the group issued those financial instruments. For example, subordinated debt refers to debt that is contractually subordinated, irrespective of the order in which individual claims would be settled if the entire group was liquidated. Similarly, all trade payables that are not contractually subordinated would be included in the 'unsubordinated' category.

BC201 To meet the proposed disclosure requirement in paragraph BC199(b), the group would have to distinguish between financial instruments issued by the parent and financial instruments issued by subsidiaries. The Board is of the view that this requirement responds to feedback from users of consolidated financial statements who wanted to know whether financial instruments were issued by the parent or a subsidiary. However, to avoid excessive disclosures and potentially onerous costs for preparers of financial statements, the Board decided not to introduce a requirement for the group to make separate disclosures about financial liabilities issued by each individual subsidiary, or about non-controlling interests in each individual subsidiary.

Terms and conditions

BC202 Users of financial statements have asked for more information about how the terms and conditions affect the nature, amount, timing and uncertainty of cash flows arising from complex financial instruments, with characteristics of both financial liability and equity, issued by an entity. They specifically need more information about the terms and conditions:

(a) of financial instruments with both financial liability and equity characteristics (paragraphs BC203–BC215), including terms and conditions that indicate priority on liquidation for such instruments (paragraphs BC216–BC218);

(b) that are affected by the passage of time (paragraph BC219); and

(c) of compound instruments (paragraph BC179–BC180).

Financial instruments with both financial liability and equity characteristics

Financial liability and equity characteristics

BC203 Financial instruments with both financial liability and equity characteristics often have features that differ from typical financial liabilities and equity instruments. For example, an instrument might be classified as a financial liability but the amount, timing and uncertainty of cash flows arising from that instrument might be similar to those of an equity instrument. Users of financial statements said they need more information about these instruments to better understand:

(a) the nature and characteristics of these instruments that are not captured by classification alone;

(b) the amount, timing and uncertainty of cash flows arising from these instruments; and

(c) the reason for their classification as financial liabilities or equity instruments.

BC204 The Board observed that disclosures about the terms and conditions of financial instruments with both financial liability and equity characteristics would meet the user information needs outlined in paragraph BC203. The disclosure requirements in IFRS 7 elicit information about those terms and conditions (such as information included in an entity's maturity analysis or risk disclosures). However, those disclosure requirements are not specifically focused on financial instruments with both financial liability and equity characteristics and do not capture all relevant aspects of those instruments' terms and conditions.

BC205 Therefore, the Board concluded that for these types of financial instruments entities should be required to disclose information about an instrument's terms and conditions that determine whether the instrument is classified as a financial liability or an equity instrument. In addition, an entity is required to disclose:

(a) 'debt-like characteristics' for an instrument classified as an equity instrument (paragraphs BC208–BC211); and

(b) 'equity-like characteristics' for an instrument classified as a financial liability (paragraphs BC212–BC215).

BC206 The Board excluded all stand-alone derivative contracts on an entity's own equity instruments from these disclosure requirements. This exclusion is because:

(a) considering the fixed-for-fixed condition (see proposed amendments to paragraph 22 of IAS 32) and the proposed clarifying principle in this Exposure Draft, the Board does not expect many equity-classified derivatives to have debt-like characteristics. One notable example of an equity-classified derivative with debt-like characteristics is a foreign currency rights issue. The Board found no evidence suggesting that users of financial statements require more information about such instruments. Because it is unlikely that other equity-classified derivatives would have debt-like characteristics, the Board proposes no additional disclosure requirements.

(b) derivatives on own equity could be classified as either financial assets or financial liabilities if they fail the fixed-for-fixed condition. Therefore, the Board considered whether to include in the scope of the proposals the derivatives on an entity's own equity instruments that are classified as financial liabilities with equity-like characteristics. The Board decided not to do so, because the proposed potential dilution disclosures would require information about instruments that are or may be settled in an entity's own equity, including derivative liabilities settled in an entity's own shares. The most important equity-like characteristic in these derivative liabilities is settlement in own equity instruments, which would be covered by the proposed potential dilution disclosures.

BC207 The Board proposes clarifying that disclosures of debt-like and equity-like characteristics would include both quantitative and qualitative information so that users of financial statements can understand the effect of these features on the nature, amount, timing and uncertainty of an entity's cash flows. The illustrative example in draft paragraph IG14E of the Implementation Guidance accompanying IFRS 7 illustrates these proposals.

An equity instrument with debt-like characteristics

BC208 The Board concluded that entities should be required to disclose information about an instrument's terms and conditions if that instrument is classified as an equity instrument but has debt-like characteristics. In reaching that conclusion, the Board considered the circumstances in which an instrument classified as an equity instrument could be viewed as having debt-like characteristics.

BC209 The cash flows arising from a typical debt instrument, such as a plain vanilla bond, usually comprise principal and interest repayments. The cash flows are usually either fixed amounts or determinable amounts based on a market rate of interest, which are payable on specified dates.

BC210 In the Board's conclusion, an equity instrument has debt-like characteristics if its terms and conditions might result in payments to the instrument holder of fixed or determinable amounts based on a market rate of interest, on specified dates. Although an entity has the contractual right to avoid these payments (or defer them until liquidation)—resulting in the instrument being classified as an equity instrument—the amount and timing of the cash flows arising from the instrument are similar to those of a typical financial liability.

BC211 Some instruments are classified as equity instruments because they do not contain a contractual obligation for an entity to deliver cash to the instrument holder (or otherwise settle the instrument in such a way that it would be a financial liability); however, they include a contractual term that creates a preference to do so. For example, a perpetual instrument might include a 'dividend stopper', whereby the entity cannot pay dividends on ordinary shares unless it has paid all outstanding coupon payments on the perpetual instrument. In the Board's conclusion, instruments with such contractual terms also have debt-like characteristics.

A financial liability with equity-like characteristics

BC212 The Board concluded that entities should be required to disclose information about an instrument's terms and conditions if that instrument is classified as a financial liability but has equity-like characteristics. In reaching that conclusion, the Board considered the circumstances in which an instrument classified as a financial liability could be viewed as having equity-like characteristics.

BC213 Equity instruments represent a residual interest in an entity's assets after deducting all of its liabilities. Typically, the cash flows of the equity instrument received by the equity holders reflect that residual nature. For example, distributions to ordinary shareholders are typically not fixed amounts (or determinable amounts based on a market rate of interest). Instead, they depend on the entity's financial performance and other changes in its economic resources. Furthermore, such distributions are not payable on specified dates but are subject to the entity's discretion. Distributions can be deferred until liquidation, at which time distributions to ordinary shareholders are made only after settling other claims against the entity's assets.

BC214 In the Board's view, a financial instrument classified as a financial liability has equity-like characteristics if its terms and conditions might result in payments to the instrument holder that either are not fixed amounts (or determinable amounts based on a market rate of interest) or might not occur on specified dates.

BC215 In the Board's view, financial liabilities that either allow an entity or include a contractual obligation for the entity to settle the instrument by delivering its own equity instruments to the instrument holder also have equity-like characteristics.

Priority on liquidation

BC216 Users of financial statements have asked for more information about the priority of financial instruments with both financial liability and equity characteristics in the event of the issuing entity's liquidation. Feedback highlighted that in addition to a general need for better and more transparent information about an entity's financing structure, there is a specific need for more information about the priority on liquidation of financial instruments with both financial liability and equity characteristics.

BC217 The priority on liquidation of a financial instrument that is classified as a financial liability and has no equity-like characteristics, such as senior bonds; or an equity instrument that has no debt-like characteristics, such as ordinary shares, is usually clear. However, the priority on liquidation of a financial instrument with both financial liability and equity characteristics might be unclear. Hence, users of financial statements said they need more information to understand the risks of and returns on instruments that have both financial liability and equity characteristics if the entity is liquidated.

BC218 To address user information needs, the Board proposes requiring the disclosure of information about the priority of each class of financial instruments with both financial liability and equity characteristics on liquidation of an entity. The disclosure would include information on:

(a) any terms and conditions of those financial instruments that indicate their priority on liquidation.

(b) any terms and conditions that could change the priority of those financial instruments on liquidation.

(c) any cases in which there is significant uncertainty about how relevant laws or regulations could affect the priority of a class of financial instruments on liquidation. Contracts commonly include a caveat about laws or regulations that might affect the priority of financial instruments on liquidation of an entity. However, a generic statement about the existence of such caveats is unlikely to be useful to users of financial statements. Hence, the Board proposes requiring disclosure only if relevant laws or regulations create significant uncertainty about their effect on the priority of the instrument on liquidation of an entity.

(d) any cases in which the contractual subordination of some instruments within a class of financial instruments differs from other financial instruments within that same class. For example, some subordinated notes might rank junior to other subordinated notes. The Board decided not to require entities to analyse and disclose the relative ranking of the individual financial instruments or tranches of a financial instrument. Although disclosure of this information might be useful for some users of financial statements, such disclosures may raise concerns about disclosure overload and result in costs to preparers that might outweigh the benefits to the users of financial statements. Therefore, the Board proposes requiring disclosure only of the cases in which there are different levels of contractual subordination within a class of financial instruments. Such a disclosure would alert investors with an interest in that information, who could then decide whether to analyse further by reviewing underlying documents (such as prospectuses for the issue of those instruments).

(e) a description of intra-group arrangements, such as guarantees, that might affect the priority of the financial instruments on liquidation of the entity that has issued them.

Passage of time

BC219 The Board concluded that passage-of-time changes do not result in the financial liability being reclassified (see draft paragraph 32B of IAS 32). However, it considered that requiring entities to disclose the contractual terms and conditions of financial liabilities that become, or stop being, effective with the passage of time would help users of financial statements understand the nature, amount, timing and uncertainty of cash flows and other features of these types of financial instruments.

Potential dilution of ordinary shares

BC220 In their feedback, users of financial statements said they need more information to help them assess the maximum potential dilution of ordinary shares arising from financial instruments that could be settled in ordinary shares, such as convertible bonds and derivatives on own equity instruments. That information helps users of financial statements understand how an entity distributes its returns to ordinary shareholders, how the entity has financed its operations in the past, and how the entity's ownership structure might change in the future when settling financial instruments that are issued at the reporting date. Information about such potential dilution is useful for investors and potential investors in the entity's ordinary shares.

BC221 Entities that apply IAS 33 *Earnings per Share* already provide some information about the potential dilution of ordinary shares, when disclosing information about diluted earnings per share.[4] The proposed disclosure requirements are not intended to duplicate or replace information already required by IAS 33. The proposed requirements would serve a different purpose and would set out different calculations to IAS 33. In particular:

(a) the objective of the proposed disclosure requirements is to help users of financial statements assess the maximum potential dilution of ordinary shares that could arise from any potential increase in the number of issued ordinary shares from settling financial instruments in issue at the reporting date. In contrast, diluted earnings per share is a performance measure; its objective as stated in paragraph 32 of IAS 33 is to provide a measure of the interest of each ordinary share in the performance of the entity over the reporting period, with a prescribed methodology to take into account the effect of dilutive potential ordinary shares outstanding during the period.

(b) unlike the calculation of diluted earnings per share, the calculation of the maximum potential dilution of ordinary shares would not be weighted for the period the instruments are outstanding and would use different assumptions. For example, the calculation of diluted earnings per share includes potential ordinary shares only if (and to the extent that) they are dilutive at the reporting date. In contrast, the calculation of the *maximum* dilution of ordinary shares (as discussed in paragraphs BC227–BC230) would include *all* potential ordinary shares, including those that are not dilutive at the reporting date.

BC222 Nonetheless, entities that apply IAS 33 would be able to use some of the information already collated when preparing the proposed disclosures on the maximum potential dilution of ordinary shares. The Board anticipates that the proposed information would not be complex or costly for entities to

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4 Broadly speaking, IAS 33 *Earnings per Share* applies to an entity whose ordinary shares are traded in a public market (or if the entity is in the process of issuing ordinary shares in a public market). See paragraph 2 of IAS 33 for more information about its scope.

provide. Although entities that do not apply IAS 33 might not have already collated information on potential dilution, the Board took that factor into account when developing the proposed disclosure requirements.

BC223 The proposed disclosure requirements relate to:

(a) additional ordinary shares that an entity might be required to deliver for each class of potential ordinary shares outstanding at the end of the reporting period (paragraphs BC225–BC235).

(b) contracts and other commitments to repurchase the entity's ordinary shares. Obligations to repurchase ordinary shares would reduce the potential dilution of ordinary shares, therefore calculation of the minimum number of shares an entity might repurchase is relevant for the maximum dilution (paragraphs BC236–BC239).[5]

(c) significant changes in the information disclosed from the prior reporting period (paragraphs BC240–BC241).

BC224 The Board concluded that the proposed disclosures would be best presented in a tabular format (to the extent possible) to convey an overall understanding of the maximum potential dilution of ordinary shares.

Additional ordinary shares to be delivered

BC225 To help users assess the maximum potential dilution of ordinary shares, the Board concluded that entities should be required to disclose the maximum number of additional ordinary shares they might be required to deliver for each class of potential ordinary shares outstanding at the end of the reporting period. In reaching this conclusion, the Board considered:

(a) how this maximum number would be calculated (paragraphs BC227–BC230); and

(b) whether and how to include additional ordinary shares that might be issued when settling share-based payment arrangements (paragraphs BC231–BC235).

BC226 The Board agreed that the quantitative information disclosed would be accompanied by a narrative description of the terms and conditions of each class of potential ordinary shares to help users understand the likelihood of maximum dilution of ordinary shares. For example, an entity could disclose that the conversion of a class of instruments into ordinary shares is contingent upon the occurrence of a specified event and describe the nature of that event.

5 Because the obligations to repurchase ordinary shares would reduce the potential dilution of ordinary shares, the maximum number of shares an entity might repurchase is not relevant for the maximum dilution calculation.

Calculation of maximum number of additional ordinary shares

BC227 The maximum number of additional ordinary shares an entity might be required to deliver for each class of potential ordinary shares outstanding would depend on the contractual terms. Entities would have to consider the contractual terms of each class of potential ordinary shares when calculating the maximum number of additional ordinary shares, using assumptions that maximise the number of additional ordinary shares it might have to deliver.

BC228 For example, an entity would assume that all outstanding written call options, warrants and conversion options in convertible instruments that could require delivery of ordinary shares are exercised. That assumption applies irrespective of whether those call options, warrants or conversion options are likely to be exercised. If a share warrant is 'out of the money' (the warrant's exercise price exceeds the entity's share price) at the reporting date, this could indicate that the warrant is unlikely to be exercised and could be considered anti-dilutive. However, the entity's share price could increase in the future during the warrant's remaining contractual life such that the warrant becomes 'in the money'. Because the disclosure's objective is to provide information that helps users assess the *maximum* possible dilution of ordinary shares, any such 'out of the money' options would be included in the calculation.

BC229 In some cases, at the end of the reporting period, an entity might not know the maximum number of additional ordinary shares it might be required to deliver when settling a financial instrument in the future. For example, settling an instrument might require the entity to deliver a variable number of its ordinary shares calculated to equal a fixed amount (or a variable amount, such as a value linked to the price of gold), with no cap on the number of ordinary shares to be delivered on settlement. The Board considered whether to propose requiring the entity to estimate the maximum number of additional ordinary shares by applying the entity's share price (or the applicable underlying variable's price) at the reporting date. However, in some cases, such a requirement could be difficult or costly for entities to apply. For example, an unlisted entity would have to estimate its share price.

BC230 Therefore, the Board concluded that if an entity does not know, at the end of the reporting period, the maximum number of ordinary shares it could be required to deliver, the entity would disclose that fact. It would not have to estimate the maximum number of additional ordinary shares it might be required to deliver for these types of potential ordinary shares.

Additional ordinary shares from settling share-based payment arrangements

BC231 Some share-based payment arrangements within the scope of IFRS 2 will or may be settled by the delivery of ordinary shares. Share-based payment arrangements are a common cause of the dilution of ordinary shares. The Board therefore considered whether to include additional ordinary shares arising from share-based payment arrangements in the calculation of the maximum potential dilution of ordinary shares.

BC232 Paragraph 45 of IFRS 2 requires the disclosure of some information that would help users to understand the maximum potential dilution of ordinary shares arising from share-based payment arrangements, such as:

(a) a description of each type of share-based payment arrangement, including the method of settlement (such as whether in cash or equity);

(b) the number and weighted average exercise prices of share options for each of specified groups of share options, including share options outstanding at the end of the period; and

(c) the range of exercise prices and the weighted average remaining contractual life for share options outstanding at the end of the reporting period.

BC233 The Board considered that one approach could be to exclude share-based payment arrangements from the scope of the proposed disclosure requirements. Users of financial statements would receive some information to help assess the maximum potential dilution of ordinary shares arising from share-based payment arrangements by considering the information disclosed from applying IFRS 2. Such an approach would be simple for entities to apply. However, feedback from users of financial statements raised concerns that such an approach would result in an incomplete calculation of the maximum potential dilution of ordinary shares.

BC234 The Board decided to propose an alternative approach that would help address user information needs while minimising any costs and complexity for preparers of financial statements. Specifically, the Board proposes including in the calculation:

(a) the total number of additional ordinary shares that would be delivered if all outstanding share options at the end of the reporting period, as disclosed in accordance with paragraph 45(b)(vi) of IFRS 2, were exercised. Including these additional ordinary shares in the calculation would not be complex or costly, because entities already gather information about these outstanding share options when applying IFRS 2.

(b) the maximum number of additional ordinary shares an entity might be required to deliver for other share-based payment arrangements if that maximum number is known at the end of the reporting period. For example, if an arrangement would require the entity to deliver 200 shares to each of 50 employees participating in the arrangement, with the only vesting condition being completion of a three-year service period, the entity would know that the maximum number of additional ordinary shares it could be required to deliver to settle the arrangement would be 10,000 ordinary shares.

BC235 In some cases an entity might not know the maximum number of additional ordinary shares it might have to deliver to settle a share-based payment arrangement. One example is a performance-based arrangement in which the number of shares deliverable upon settlement is based on the increase in the entity's revenue or share price over the vesting period. Another example is an employee share purchase plan in which participating employees contribute a specified percentage of their salaries over the vesting period. In this case, the number of shares to be delivered would depend on those employees' salaries over the vesting period. If the entity does not know the maximum number of additional ordinary shares it could be required to deliver to settle a share-based payment arrangement, it would have to disclose that fact. It would not have to estimate the maximum number of additional ordinary shares it might be required to deliver for these types of share-based payment arrangements. This approach is consistent with the proposed approach when similar circumstances arise for other instruments (see paragraph BC230).

Contracts and other commitments to repurchase ordinary shares

BC236 Contracts and other commitments to repurchase ordinary shares would reduce the maximum potential dilution of ordinary shares arising from the settlement of potential ordinary shares outstanding at the end of the reporting period. The Board concluded that disclosures on the maximum potential dilution of ordinary shares would include information about such contracts and other commitments. Without such information, the information disclosed about the maximum potential dilution of ordinary shares would be incomplete and could give the impression of greater potential dilution of ordinary shares than would be the case when contracts and other commitments to repurchase shares are taken into account.

BC237 Therefore, the Board proposes requiring the disclosure of:

(a) the minimum number of ordinary shares an entity is required to repurchase (calculated as discussed in paragraphs BC238–BC239); and

(b) a narrative description of contracts and other commitments to repurchase ordinary shares.

Calculation of minimum number of shares to be repurchased

BC238 Consistent with the objective of providing information about the *maximum* potential dilution of ordinary shares, the Board concluded that an entity is required to disclose the *minimum* number of ordinary shares it is required to repurchase. The minimum number would be calculated assuming that:

(a) the entity repurchases the minimum number of shares required under the terms of forward contracts and other commitments to repurchase ordinary shares. Commitments are included for completeness because they could arise before an entity enters into a contract with a specific counterparty to repurchase shares; and

(b) the counterparty does not exercise any written put options or the entity does not exercise any purchased call options on its own shares, consistent with the objective of providing information about the maximum potential dilution of ordinary shares (except as discussed in paragraph BC239).

BC239 However, in some cases, an entity might mitigate the potential dilution of ordinary shares by entering into derivatives on its own shares. For example, the entity might purchase a call option on its own shares to mitigate the potential dilution of convertible bonds. In this situation, the assumption that the entity does not exercise the purchased call option would ignore the interdependencies between that option and the potentially dilutive instrument (the convertible bonds). The Board therefore concluded that the calculation of the minimum number of ordinary shares the entity is required to repurchase would include shares that would be repurchased on exercise of a purchased call option if:

(a) the entity purchased that option for the specific purpose of repurchasing ordinary shares in the event that it was required to deliver ordinary shares on settlement of specific financial instruments; and

(b) the option has the same exercise price and same exercise date (or exercise period) as those financial instruments.

Significant changes since the prior reporting period

BC240 The maximum potential dilution of ordinary shares could change significantly from one reporting period to the next. For example, an entity might issue warrants over its own shares during the reporting period or holders of convertible bonds might exercise an option to convert those bonds into ordinary shares. The Board therefore considered whether to require a reconciliation of the movement during the reporting period. This reconciliation would help users understand the causes of any significant changes since the prior reporting period and the extent to which each cause contributed to those changes.

BC241 However, stakeholders indicated that any such reconciliation could be complex and costly for entities to prepare and might result in information that is difficult for users of financial statements to understand, especially in the case of large, complex entities. As an alternative, the Board decided to propose requiring a narrative explanation of any significant changes from the prior reporting period. In the Board's view, this approach would provide useful information to users of financial statements in a way that would not be complex or costly for preparers to provide.

Puttable financial instruments classified as equity instruments

BC242 As noted in paragraph BC100B of the Basis for Conclusions on IAS 1, the Board previously decided to require entities with puttable financial instruments classified as equity to disclose additional information to allow users of financial statements to assess any effect on the entity's liquidity arising from the ability of the holder to put the instruments to the issuer. Financial instruments classified as equity usually do not include any obligation for the entity to deliver a financial asset to another party. Therefore, the Board had concluded that additional disclosures are needed in these circumstances. In particular, the Board decided to require entities to disclose the expected cash outflow on redemption or repurchase of those financial instruments that are classified as equity and to disclose information about how that amount was determined. That information allows liquidity risk associated with the put obligation and future cash flows to be evaluated.

Financial instruments that include an obligation for an entity to purchase its own equity instruments

BC243 The Board concluded that users of financial statements need information that helps them to understand the accounting treatment for an entity's obligations to purchase its own equity instruments. This information includes the amounts recognised in equity and the amounts recognised in profit or loss. The Board considered that some information might currently be provided through IFRS 7 disclosures about the entity's exposure to and management of liquidity risk. In addition, information might also be provided by the requirement in paragraph 79(a)(v) of IAS 1 to disclose, for each class of share capital, the rights, preferences and restrictions attached to that class, including restrictions on the repayment of capital. However, the Board noted that these disclosures are not specifically related to instruments that contain obligations to purchase own equity instruments. Therefore, the Board proposes requiring entities to provide more comprehensive disclosures in a single note to the financial statements to meet user information needs.

Significant judgements

BC244 Paragraph 15 of IAS 32 requires an issuer of a financial instrument to classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument. However, in some cases, determining the appropriate classification involves significant judgement. For example:

(a) the Board proposes requiring a factors-based approach to help an entity apply its judgement in classifying a financial instrument with a contractual obligation to deliver cash (or otherwise settle the instrument in such a way that it would be a financial liability) at the discretion of the issuer's shareholders. Judgement would be required in assessing whether a shareholder decision is treated as the entity's decision. Based on this assessment, an entity determines whether it has an unconditional right to avoid delivering cash (or otherwise settling a financial instrument in such a way that it would be a financial liability).

(b) the Board proposes that for a derivative on own equity instruments to meet the fixed-for-fixed condition in IAS 32 (see proposed amendments to paragraph 22 of IAS 32), the amount of consideration to be exchanged for each of an entity's own equity instruments is required to be denominated in the entity's functional currency and either fixed or variable solely because of a preservation or a passage-of-time adjustment or both (see draft paragraph 22B of IAS 32). The entity might be required to apply judgement in determining whether an adjustment is a preservation adjustment or a passage-of-time adjustment and whether the adjustment is consistent with the fixed-for-fixed condition.

BC245 The judgements outlined in paragraph BC244 directly affect classification of financial instruments and help users of financial statements understand why specified instruments are classified as financial liabilities or equity instruments. The Board therefore concluded that entities are required to disclose significant judgements made in classifying financial instruments (including all stand-alone derivative contracts) as financial liabilities or equity instruments. Together with the requirements in paragraph 122 of IAS 1, as referred to in draft paragraph B5A of IFRS 7, these disclosures would ensure users of financial statements are aware of any significant judgements involved in classifying a financial instrument as a financial liability or an equity instrument.

Proposed amendments to IAS 1 *Presentation of Financial Statements*

BC246 The quality of information an entity provides to users of financial statements can be raised by improving presentation and disclosure, instead of relying solely on the classification of financial instruments to provide useful information about similarities and differences between the claims of an entity's investors. Over the years, stakeholders have said that the information entities provide in their financial statements about equity instruments they have issued is too limited.

BC247 In the 2018 Discussion Paper the Board discussed the possibility of introducing presentation requirements relating to the attribution of profit or loss, other comprehensive income and net assets between ordinary shareholders and other equity holders.

BC248 The attribution proposals in the 2018 Discussion Paper related to derivatives and non-derivatives. Specifically:

(a) for derivatives, the Board did not form a preliminary view but considered various approaches ranging from a full fair value approach to not requiring attribution but using disclosure. The core idea was to show the value that has been given away to derivative equity holders.

(b) for non-derivatives, the Board's preliminary view was that attribution needed to be based on the requirements in IAS 33 for calculating earnings per share, which most commonly involves adjustments for preference dividends or participating equity instruments.

BC249 Most respondents who provided feedback on the proposals for derivative equity instruments disagreed with the possible attribution approaches because they believed the benefits of the resulting information would not outweigh the cost of preparing it. Many respondents suggested that the Board pursue a disclosure solution instead. Some were of the view that the disclosures proposed in the Discussion Paper would be enough to provide useful information about equity instruments.

BC250 Some respondents who provided feedback on the attribution proposals for non-derivative equity instruments supported the proposals and agreed that IAS 33 should be the basis for attribution. However, some respondents disagreed because they believed disclosure is better suited to provide the information than expanding presentation in the primary financial statements.

BC251 Users of financial statements need transparency about whether an entity has issued instruments (other than ordinary shares) classified as equity, preferably without having to go through multiple notes to the financial statements to piece together the information needed to calculate ratios. The Board considered whether specifying further sub-classes of equity instruments in the statement of financial position would be a feasible solution to provide transparency about the equity instruments issued by the entity. This approach was rejected for several reasons:

(a) different entities issue different types of equity instruments (for example, non-redeemable preference shares, perpetual instruments, derivative equity instruments and equity components of compound instruments) in addition to ordinary shares, depending on their financing or regulatory requirements.

(b) if the Board were to require specified line items for equity instruments in the statement of financial position, questions might arise about whether these equity instruments are required to be presented in separate columns in the statement of changes in equity and as separate line items as part of the attribution section of the statement of comprehensive income. Questions might also arise as to whether the carrying amounts of these other equity instruments are required to be updated to include total comprehensive income attributable to holders of these instruments—for example, cumulative coupons for the period.

(c) feedback on the 2018 Discussion Paper provided no clear request from users of financial statements for further line items in the statement of financial position, and not all users support additional line items in the primary financial statements. For example, in the context of separate presentation of financial liabilities with equity-like returns, some users said that separate presentation would complicate their understanding of the statements of comprehensive income and financial position.

(d) the proposed disclosures on terms and conditions, potential dilution, and the nature and priority of claims would provide transparency about whether an entity has issued other equity instruments. The proposed disclosures would identify items or areas about which users of financial statements might seek additional information.

(e) entities are not precluded from presenting additional line items in the statement of financial position. Entities have to apply judgement and decide whether they need to present additional line items or disaggregate existing line items for the different types of equity instruments in accordance with paragraphs 55 and 77 of IAS 1. Entities will also be subject to any future requirements following finalisation of the Primary Financial Statements project relating to the role of the primary financial statements, required line items, additional line items and the principles for aggregation and disaggregation.

BC252 Users of financial statements expressed a need for better information about the distribution of profits among holders of equity instruments to understand how an entity distributes its returns to ordinary shareholders. Paragraph 81B of IAS 1 requires an entity to present profit or loss and comprehensive income for the period attributable to non-controlling interests and owners of the parent. Owners are defined in paragraph 7 of IAS 1 as holders of instruments classified as equity. The Board considered but rejected a proposal to present in the statement of comprehensive income, profit attributable to non-controlling interests and dividends attributable to preference and other equity holders as line-item deductions from net profit for the year to arrive at profit attributable to ordinary shareholders.

BC253 Such a presentation would not comply with requirements in IFRS Accounting Standards, namely that:

(a) profit attributable to non-controlling interests is required not to be presented as a deduction from net profit for the year. This amount is different to an expense line item. Paragraph 81B of IAS 1 explicitly requires an entity to present the allocation of profit or loss and other comprehensive income for the period 'in addition to the profit or loss and other comprehensive income sections'.

(b) dividends paid or payable by an entity on equity instruments cannot be included in the statement of comprehensive income, as seen in:

  (i) paragraph 106(d)(iii) of IAS 1, which requires distributions to owners to be presented in the statement of changes in equity. Distributions to holders of equity claims are not items of expense.

  (ii) paragraph 107 of IAS 1, which requires the amount of dividends recognised as distributions to owners during the period, and the related amount of dividends per share, to be presented either in the statement of changes in equity or in the notes.

  (iii) paragraph 13 of IAS 33, which explains that dividends on preference shares classified as liabilities are included in the determination of profit or loss for the period attributable to ordinary equity holders of the parent entity.

BC254 The Board considered whether the requirements in IAS 1 could be read as requiring separate presentation of amounts relating to ordinary shareholders from amounts relating to other equity holders. However, the Board concluded that amendments are required to meet the needs of investors in ordinary shares for transparency and a clearer distinction of returns attributable to ordinary shareholders and returns attributable to others. These proposed amendments explicitly require presentation of amounts attributable to ordinary shareholders separately from other equity holders.

BC255 The proposed amendments to IAS 1 affect the statement of financial position, the statement of changes in equity, the statement of comprehensive income and the notes to the financial statements. The proposals also include new illustrative examples in the Implementation Guidance that accompanies IAS 1, showing additional line items and the use of columns to provide the additional information while still presenting suitable subtotals.

BC256 The presentation of equity attributable to ordinary shareholders and other equity holders in the draft illustrative example is based on the contractual terms applicable at the reporting date. Therefore, reserves attributed to other equity holders do not include amounts expected to become attributable to those equity holders upon the occurrence of future events.

Proposed amendments to [IFRS XX *Subsidiaries without Public Accountability: Disclosures*]

BC257 The Board expects to issue the new IFRS Accounting Standard [IFRS XX *Subsidiaries without Public Accountability: Disclosures*] before the amendments proposed in this Exposure Draft are finalised. The Board is therefore proposing amendments to [IFRS XX] to include the disclosures the Board considers appropriate for eligible subsidiaries. An eligible subsidiary is not publicly accountable and has an ultimate or intermediate parent that produces consolidated financial statements available for public use that comply with IFRS Accounting Standards.[6]

BC258 In assessing which disclosure requirements to propose for eligible subsidiaries, the Board was guided by the broad principles from paragraph BC34 of the Basis for Conclusions on the Exposure Draft *Subsidiaries without Public Accountability: Disclosures*, which are that:

(a) users of financial statements of [eligible subsidiaries] are particularly interested in information about short-term cash flows and about obligations, commitments or contingencies, whether or not recognised as liabilities. Disclosures in full [IFRS Accounting Standards] that provide this sort of information are necessary for [eligible subsidiaries] as well.

(b) users of financial statements of [eligible subsidiaries] are particularly interested in information about liquidity and solvency. Disclosures in full [IFRS Accounting Standards] that provide this sort of information are necessary for [eligible subsidiaries] as well.

(c) information about measurement uncertainties is important for [eligible subsidiaries].

(d) information about an entity’s accounting policy choices is important for [eligible subsidiaries].

6 For this purpose, an entity has public accountability if its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments, or if it holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses.

(e) disaggregation of amounts presented in an [eligible subsidiary's] financial statements is important for an understanding of those financial statements.

(f) some disclosures in full [IFRS Accounting Standards] are more relevant to investment decisions in public capital markets than to the transactions and other events and conditions encountered by typical [eligible subsidiaries].

BC259 Applying the principles for reducing disclosures involves exercising judgement about how to meet the particular needs of users of eligible subsidiaries' financial statements without imposing costs on preparers that exceed the benefits of the disclosures. Because of this judgement, the proposed disclosure requirements for eligible subsidiaries do not include all the proposed disclosures for entities in the scope of IFRS 7.

BC260 In the Board's view, the interest of users of eligible subsidiaries' financial statements in short-term cash flows means that disclosures are necessary on equity-like and debt-like features (paragraphs BC203–BC215) and passage-of-time changes. Proposed requirements on instruments containing obligations to purchase own equity instruments (paragraph BC243) and financial liabilities with contractual obligations to pay amounts based on an entity's performance or changes in the entity's net assets (paragraphs BC181–BC189) address users' need for information on disaggregation, and the disclosure requirements on significant judgements (paragraphs BC244–BC245) provide information about an entity's accounting policies.

BC261 The Board concluded that the proposed disclosures on the nature and priority of claims against an entity on liquidation (paragraphs BC191–BC201) and terms and conditions about priority on liquidation (paragraphs BC216–BC218) are both helpful to users of eligible subsidiaries' financial statements because they relate to an entity's liquidity and solvency.

Transition

BC262 The Board proposes retrospective application of the proposed amendments, which would maximise the consistency of financial information between periods and also facilitate analysis and understanding of comparative information.

BC263 The Board concluded that the benefits of retrospective application would outweigh the costs because:

(a) the proposals relating to classification are not very different from the requirements in the issued Standards because the objective of the project is to make clarifying amendments to the underlying principles in IAS 32 instead of fundamentally changing any requirements.

(b) comparative information would help users of financial statements identify and assess changes and trends in an entity's liquidity and solvency. However, to minimise costs, the Board proposes not to require the restatement of information for more than one comparative period, even if an entity chooses or is required to present more than one comparative period in its financial statements.

(c) the costs of obtaining the information relating to the classification proposals are not expected to be excessive because most information would be readily available to preparers through their current information technology systems.

BC264 The proposed amendments to IAS 32 relating to classification clarify the underlying principles and aim to provide a clear rationale for the requirements of the Standard. The Board acknowledges that addressing accounting diversity by clarifying relevant classification principles would mean that some entities have to change their accounting policies when initially applying the proposed amendments. As a result, a retrospective change in classification might be required for some of their issued financial instruments. Some instruments currently classified as financial liabilities might have to be accounted for as equity instruments and vice versa.

BC265 In applying changes in classification from equity instruments to financial liabilities on initial application of the proposed amendments, entities that already apply IFRS Accounting Standards could face difficulties in applying the proposed amendments retrospectively. For example, hindsight might be required to determine the effective interest rate or apply the effective interest method in IFRS 9 retrospectively. The Board is therefore proposing specific transition requirements for equity instruments required to be classified as financial liabilities. If it is impracticable (as defined in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*) to apply the effective interest method in IFRS 9 retrospectively, the fair value at the transition date would be treated as the amortised cost of the financial liability at that date.

BC266 Similar to the transition requirements in IFRS 1 *First-time Adoption of International Financial Reporting Standards* and in paragraph 97C of IAS 32, the Board proposes an entity not be required to separate a compound financial instrument with a contingent settlement provision into separate liability and equity components if the liability component is no longer outstanding at the date of initial application of the proposed amendments. If the proposed amendments were applied retrospectively, a compound instrument with a contingent settlement provision that could require settlement on a specified date in the future would have to be separated into liability and equity components from the instrument's inception. For some instruments, the liability component might no longer be outstanding at the date of initial application of the proposed amendments and, consequently, separating these compound financial instruments would be of little benefit because retrospective application would involve separating two components of equity.

BC267 An entity is required to apply the disclosure requirements of IAS 8 unless another IFRS Accounting Standard specifies otherwise. In initially applying the proposed amendments, the disclosures in paragraph 28 of IAS 8 would thus apply. The Board proposes that entities are not required to disclose the quantitative information that would otherwise be required by paragraph 28(f) of IAS 8. The cost of providing this disclosure would exceed the benefits particularly because clarifying the underlying principles in IAS 32 could affect many line items in the financial statements due to the current diversity in how the requirements in IAS 32 are applied in practice to complex financial instruments.

BC268 The Board also proposes specific transition disclosures if there has been a change in classification resulting from initial application of the proposed requirements. The Board concluded that it would be particularly beneficial to alert users of financial statements to these changes in the reporting period that includes the date of initial application of the proposed amendments.

BC269 The Board is proposing no specific transition requirements in relation to IAS 34 *Interim Financial Reporting* for interim financial reports issued within the annual period in which an entity first applies the proposed amendments. The entity would therefore apply judgement in determining what to disclose to meet the requirement for disclosing information about the nature and effect of changes in accounting policies, and how much information to provide to update the relevant information presented in the most recent annual financial report.

BC270 The Board is also proposing no additional transition requirements for first-time adopters. Paragraph D18 of IFRS 1 allows an exemption from the requirement to split a compound financial instrument into separate liability and equity components if the liability component is no longer outstanding at the date of transition to IFRS Accounting Standards. Furthermore, paragraph B8C of IFRS 1 contains a transition exemption if it is impracticable (as defined in IAS 8) for an entity to apply the effective interest method in IFRS 9 retrospectively. This exemption is similar to the transition requirements proposed for entities already applying IFRS Accounting Standards and, therefore, no further transition exemption is necessary for first-time adopters.

Alternative view on Exposure Draft *Financial Instruments with Characteristics of Equity*

Alternative view of Mr Uhl

AV1 Mr Uhl voted against the publication of the Exposure Draft because he disagrees with two aspects of the Exposure Draft, both pertaining to the accounting for stand-alone derivative contracts that contain an obligation to redeem an entity's own equity instruments. First, he disagrees with the decision not to reconsider the requirement in paragraph 23 of IAS 32 that requires—for stand-alone derivative contracts that require a future exchange of cash (or other assets) for the entity's own equity instruments—the separate recognition of the contract's right and obligation, often referred to as the 'gross presentation'. Second, within the requirements for gross presentation, for contracts to purchase ownership interests of a subsidiary, he disagrees with the proposed requirement in draft paragraph AG27B of IAS 32 that the offsetting debit be recognised within the ownership interests of the equity holders of the parent instead of against non-controlling interests.

AV2 Stand-alone derivative contracts that require an entity to purchase from a counterparty its own (or a subsidiary's) equity instruments in exchange for cash contain an obligation for the entity to transfer an asset(s) as well as a right to receive its own, or a subsidiary's, equity instruments. Until the obligation is settled or the right is extinguished—while the activities underlying the obligation and right are executory or yet unperformed—the obligation and right do not exist separately. Generally, stand-alone derivative contracts encompassing rights and obligations associated with a future exchange are accounted for as a single asset, liability or equity instrument. For example, the counterparty would account for the contract as a single instrument. The proposed accounting deviates from the single instrument accounting and 'grosses up' the contract into a recognised liability and an amount debited to equity representing the future right to receive equity instruments. Mr Uhl disagrees that the right not being for an economic resource of the entity justifies separating the instrument into components.

AV3 Mr Uhl believes an entity should account for the contract as a single unit and, because the contract contains an obligation, that single recognised unit would not be within equity. Instead, the entity should account for the contract—which meets the definition of a derivative—as a stand-alone derivative.

AV4 In Mr Uhl's view, the basis for the gross presentation accounting involving the separate recognition of executory transfers within contracts for the purchase of an entity's own equity could have potentially adverse consequences for other contracts. For example, a forward derivative contract (or purchased option) to sell a fixed number of the entity's own (or a subsidiary's) equity instruments provides the entity with a right to receive economic resources (for example, cash) without an obligation that would be considered a liability. Using the same basis for gross presentation could result in the entity separately recognising an asset for such a right with a corresponding increase in equity. Mr Uhl finds this potential extension of the basis underlying the gross presentation accounting of concern and believes it should have been reconsidered.

AV5 Given the gross presentation requirements in paragraph 23 of IAS 32, Mr Uhl also disagrees with the proposed accounting for the separately recognised debit for those contracts involving the required purchase of a subsidiary's equity instruments (the future purchase of non-controlling interests). In the consolidated financial statements, an entity reports separately, as a non-controlling interest within equity, the amounts associated with subsidiaries' equity held by parties other than the controlling entity. For stand-alone derivative contracts for the purchase of a subsidiary's shares from non-controlling shareholders, the proposed accounting requires a debit entry against a component of equity other than non-controlling interests, as well as the recognition of the obligation. Mr Uhl disagrees with this proposal and believes the debit entry should be presented as part of non-controlling interests—for example, as a separate component presented after non-controlling interests and within a subtotal for net non-controlling interests.

AV6 Under these contracts, in order to receive the resources (for example, cash) an entity is obligated to deliver, the counterparty must simultaneously deliver to the entity the specified equity instruments—the counterparty has either a claim on the consideration specified in the contract or a claim on the subsidiary's net assets, but not both. Mr Uhl believes that the proposed accounting to recognise both a liability and the full amount of non-controlling interest is not representationally faithful because it overstates claims on the entity's net assets held by parties other than the entity's controlling owners. The placement of this debit entry also understates the controlling interests' claim on the entity's net assets.

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