STAFF PAPER

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IASB® meeting

Project	Financial Instruments with Characteristics of Equity (FICE)		
Paper topic	Disclosures and presentation of equity instruments		

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Objective

1. In this paper the staff summarise the detailed feedback received on the second half of Section 6 and Section 7 of the Discussion Paper *Financial Instruments with Characteristics of Equity* (DP), which set out the Board's preferred approach to presentation of equity instruments and disclosures respectively.

2. This paper is structured as follows:

   (a) Background and questions in the DP (paragraphs 3–6);

   (b) Key messages from the feedback received (paragraphs 7–9);

   (c) Presentation of equity instruments (paragraphs 10–17);

   (d) Disclosure (paragraphs 18–35).

Background and Questions in the DP

Presentation of equity instruments

3. The DP sets out the Board's preliminary views on presentation of equity instruments and proposed attribution of total comprehensive income as described in paragraphs 3(a)–3(b) below. In the Board's view, such information would be useful for assessing the distribution of returns among different equity instruments:

   (a) For non-derivative equity instruments, the attribution should follow the existing calculation for basic earnings per share in IAS 33 *Earnings per Share*, which most commonly involves dividends paid or declared. Entities would present these amounts on the face of financial statements separately from dividends paid on ordinary shares.

   (b) For derivative equity instruments, three approaches to attribution are considered in the DP and the Board has not reached a preliminary view on which method is preferred. The Board is aware of challenges posed by these approaches and may consider a disclosure-only approach.

4. The Board asked the following question:

> **Question 8**
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> The Board's preliminary view is that it would be useful to users of financial statements assessing the distribution of returns among equity instruments to expand the attribution of income and expenses to some equity instruments other than ordinary shares. Do you agree? Why, or why not?
>
> The Board's preliminary view is that the attribution for non-derivative equity instruments should be based on the existing requirements of IAS 33. Do you agree? Why, or why not?
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> The Board did not form a preliminary view in relation to the attribution approach for derivative equity instruments. However, the Board considered various approaches, including:
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> (a) a full fair value approach;
>
> (b) the average-of-period approach;
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> (c) the end-of-period approach; and

(d) not requiring attribution, but using disclosure [on fair value of equity instruments as well as potential dilution of ordinary shares]. Which approach do you think would best balance the costs and benefits of improving information provided to users of financial statements?

Disclosure

5. To provide more information about equity instruments and financial liabilities, the DP set out the following disclosure objectives and information that might be disclosed to meet the objectives:

Disclosure objectives	**Information that might be disclosed to meet such disclosure objectives**
Priority of financial instruments on liquidation	
To provide information to users of financial statements about the relative ranking of financial liabilities and equity instruments	(a) a list of all financial liabilities and equity instruments in the order of their priority using either the carrying amounts or the fair value; (b) for each group or category of financial liability and equity instrument, information about: (i) terms and conditions that indicate the priority within the entity's capital structure; (ii) terms and conditions that could lead to changes in priority; (iii) terms and conditions that indicate any promised returns and/or rights to dividends or other distributions; and (iv) any other contractual features that could affect holders' rights to share in an

	entity's economic resources and returns; and (c) if there is any change in the priority of any group of financial instruments, information about the reason(s) for the change.
Potential dilution of ordinary shares	
To provide information to help users of financial statements assess the potential dilution of ordinary shares arising from financial instruments that could be settled by issuing ordinary shares	(a) a list at the end of each reporting period of all financial instruments that could dilute the ordinary shares; (b) for each group of potentially dilutive financial instruments, terms and conditions including how the number of ordinary shares required for settlement is determined, dates of share settlement and number of shares to be delivered at settlement based on the current conditions at the end of reporting period; and (c) a reconciliation of the movement in the number of ordinary shares outstanding, and in the maximum number of additional potential ordinary shares, during the period.
Contractual terms and conditions	
To provide information about contractual terms and conditions that are relevant to understanding the timing and amount cash flows	(a) terms and conditions that are relevant to determining the settlement amount. Such terms and conditions might include information about the financial instrument's principal amount, interest rate, indices and whether and how the settlement amount depends on the entity's available economic

	resources and the effect of any options and contingencies; and (b) the timing of settlements, including the effect of any options and contingencies.

6. The Board asked the following question:

Question 9

The Board's preliminary view is that providing the following information in the notes to the financial statements would be useful to users of financial instruments:

(a) information about the priority of financial liabilities and equity instruments on liquidation. Entities could choose to present financial liabilities and equity instruments in order of priority, either on the statement of financial position, or in the notes.

(b) information about potential dilution of ordinary shares. These disclosures would include potential dilution for all potential issuance of ordinary shares.

(c) information about terms and conditions should be provided for both financial liabilities and equity instruments in the notes to the financial statements.

Do you agree with the Board's preliminary view? Why, or why not?

How would you improve the Board's suggestions in order to provide useful information to users of financial statements that will overcome the challenges identified in paragraphs 7.10 and 7.29 [of the DP]?

Are there other challenges that you think the Board should consider when developing its preliminary views on disclosures?

Key messages

7. **Would the attribution of total comprehensive income to equity instruments other than ordinary shares provide useful information**? Many respondents agreed with the Board that it would be useful for investors to have information about the distribution of returns among the different types of equity instruments and supported the objective of the presentation proposals for equity instruments. However, most respondents were not supportive of any of the attribution approaches for derivative equity instruments proposed in the DP because they

believed the benefits of the resulting information would not outweigh the cost of preparation. Many respondents' feedback on this topic focused on the proposals for derivative equity instruments. Out of the respondents who provided specific feedback on the attribution proposals for non-derivative equity instruments, some supported the proposals for non-derivative equity instruments. Most respondents who supported the proposals for non-derivative equity instruments did so in spite of not supporting the proposals for derivative equity instruments.

8. **What do respondents propose instead to improve information provided about financial instruments issued?** Many respondents suggested that rather than developing an attribution approach for derivative equity instruments, the Board pursue a disclosure solution instead. In their view, the disclosures proposed in the DP along with the information already required by IAS 33 *Earnings per Shares* would be sufficient in meeting the Board's objective of providing useful information about equity instruments. However, some respondents also suggested that IAS 33 requirements could be improved and encouraged the Board to do some further work in this regard.

9. **Do respondents support the proposed disclosures for financial liabilities and equity?** Most respondents were broadly supportive of the disclosure proposals for financial liabilities and equity. However, some highlighted potential challenges and suggested solutions for the Board to consider.

Presentation of equity instruments

Non-derivative equity instruments

10. As explained in paragraph 7 of this Agenda Paper, out of those who provided feedback specifically on non-derivative equity instruments, some respondents, including some users of financial statements, supported the proposed attribution approach and agreed that IAS 33 should be the basis for attribution. Those who disagreed did so mainly because such a requirement would be onerous for non-listed entities that do not apply IAS 33. Some also disagreed because they believe disclosure is better suited to provide the information than expanding primary financial statements. They would prefer the Board to focus on addressing existing

limitations of IAS 33 and investigate whether the same information can be provided through IAS 33 instead. Some respondents who agreed with the proposals also suggested that the scope of attribution be limited to only those who currently apply IAS 33.

Derivative equity instruments

11. Most respondents did not agree with the proposed attribution for derivative equity instruments because they believed the benefits of the resulting information would not outweigh the cost of preparation. They did not think the resulting information would be useful for one or more of the following reasons:

    (a) All proposed attribution methods require determining the fair value of derivative equity instruments . For non-listed entities in particular, estimating the fair value of their own equity instruments could be subject to significant judgement and respondents questioned the reliability of the attribution using fair value as the basis for attribution.

    (b) Total comprehensive income does not capture all changes in the fair value of assets and liabilities. Attribution of total comprehensive income using fair value as the basis therefore has limited value.

    (c) Derivatives do not represent the existing interest in the economic resources of the entity and do not entitle the holders to a share of current period earnings. Attribution of the current period income could therefore be misleading.

    (d) The discretionary nature of the distribution makes it hard to prescribe a method of attribution that would satisfy the information needs for all equity instruments.

    (e) The complexity involved in the attribution methods makes it hard to understand.

    (f) Equity should not be remeasured subsequent to initial recognition.

12. While disagreeing with the proposed attribution for derivative instruments, a few respondents expressed their preference on the attribution method should the Board

decide to proceed with an attribution principle. Most of these respondents preferred the full fair value approach, noting that it will provide the information that would have been available applying the ‘narrow equity’ approach.[1] The remainder of these respondents considered the average-of-period approach to be most logical basis for allocating total comprehensive income. A few respondents raised concerns that the full fair value approach and the end-of-period approach could result in a negative amount being attributed to ordinary shares even if total comprehensive income as a whole is a positive amount. These respondents were concerned about potential consequences on the amount of distributable reserves and regulatory capital calculation.

Suggested ways to provide further information about equity instruments

13. Many respondents who disagreed with the proposed attribution principle for derivative equity instruments recommended the Board pursue a disclosure solution instead. Some of these respondents added that disclosures proposed in Section 7 of the DP would be sufficient in achieving the Board’s objective.

14. Out of those who have commented specifically on the disclosure of fair value for derivative equity instruments, only few respondents were supportive. Most of the others said that the benefits of fair value disclosure for equity instruments would not outweigh the cost citing reasons similar to those described in paragraph 11(a).

15. Many respondents requested the Board to revisit IAS 33 instead of developing attribution requirements. They highlighted current limitations of IAS 33 similar to those the Board identified in the DP. On the other hand, a few respondents expressed the view that the existing requirements in IAS 33 are sufficient.

16. On the presentation of financial position, a few respondents said that it could be improved by presenting equity instruments using sub-classes, for example, distinguishing existing shareholders from potential shareholders or other equity holders.

[1] Applying the ‘narrow equity’ approach, only ordinary shares would be classified as equity.

17. A few respondents noted that the extent to which an entity's reserves is distributable to shareholders, is determined by local laws and/or in accordance with the parent company GAAP, which may not be based on IFRS Standards. They consider this to be important information and suggested any proposals should not obscure that information.

Disclosure

Overall disclosure proposals

18. Most respondents were supportive of the disclosure proposals set out in the DP. A few respondents further said that the Board should proceed with improving disclosures even if the Board decided not to proceed with the classification and presentation proposals in the DP.

19. However, a few respondents did not support some of the proposed disclosures mainly for one of the following reasons:

    (a) a few disagreed with the priority on liquidation disclosure because in their view the limitations described in paragraph 21 mean that any resulting disclosure will be of limited value.

    (b) a few also expressed concern about the scope of the potential dilution disclosures and said that such disclosure will be onerous for non-listed entities that do not apply IAS 33 currently; and

    (c) a few disagreed with the contractual terms and conditions disclosure because of the concern over disclosure overload.

Priority on liquidation

20. Most respondents were supportive of the proposals, with many agreeing that information about priority of financial instruments on liquidation is useful because users of financial statements currently perform their own analysis based on limited information. Furthermore, listing financial instruments by priority on liquidation would help users of financial statements assess how any potential shortfall or surplus in economic resources is allocated amongst the different claims.

21. In contrast, a few respondents disagreed that priority of financial instruments on liquidation should be disclosed for one or more of the following reasons. In their view, such disclosure:

(a) is not expected to be meaningful for a large consolidated group because of the complexity involved (see paragraph 24).

(b) can be misleading if it only considers contractual terms without taking into account the effects of law and regulations and related party arrangements such as intercompany guarantees. If such effects are required to be taken into account on the other hand, such an approach would be costly to implement, for example, legal opinion needs to be obtained in some situations to determine the ranking of instruments.

(c) is unlikely to be reflective of the financial position of a company in the event of liquidation, which is likely to be very different from its position as at reporting date.

(d) could pose legal risk, eg disclosure could potentially be challenged in court for legal actions by instrument holders.

Provision of information on the face of financial statements vs in the notes

22. Most respondents who provided feedback on this specific question supported the priority information to be provided in the notes to the financial statements. The main reason cited was that financial statements are prepared on a going concern basis and that disclosure of information about the priority on liquidation only in the notes should help prevent mix up of concepts. In their view, allowing entities a choice between the notes and presentation on the face of financial statements will reduce comparability. Furthermore, disclosure in the notes will allow contractual terms and conditions to be explained along with priority on liquidation, thereby presenting all relevant information in the same place.

Fair value vs carrying amounts

23. All respondents who provided feedback on this matter supported that the carrying amounts of financial instruments should be disclosed rather than their fair value because it would allow reconciliation to financial statements. Also, fair value-

based disclosure will be costly as entities would be required to fair value all equity instruments when that information is not used elsewhere in the financial statements.

Challenges and proposed solutions

24. Many respondents including those who are supportive of the proposed disclosures have highlighted a number of challenges that would arise when providing the disclosure, most of which relate to providing such information on a consolidated basis. Respondents noted that doing so could result in disclosures that are misleading in some circumstances for the following reasons:

    (a) It is the individual legal entity, not a group itself, that is a party to a contract and that is subject to claims on its economic resources in liquidation. In the event of liquidation, financial instruments within a group will represent claims against different pools of assets within the group, ie assets of each legal entity that issued such financial instruments to holders that are external to the consolidated group. Respondents feared that the disclosure of priority on a consolidated level would misrepresent the assets available to settle the financial instruments.

    (b) Providing such information on a consolidated basis would imply the liquidation of the entire group, which will often not be the case. If a group was in financial distress, it is more likely that claims would be settled by disposing assets, businesses or individual legal entities within the group rather than by liquidating the entire group.

    (c) Additional complexity will exist for a group that has subsidiaries in multiple jurisdictions because they are subject to different legal requirements which would affect the priority on liquidation.

    (d) Complexity increases with the number of intragroup agreements such as intercompany loans and guarantees, which could affect the priority of financial instruments on liquidation.

25. Other challenges noted by respondents relate to the following:

(a) Similar to the point described in paragraph 21(b), priority on liquidation is subject to insolvency and bankruptcy laws. Priority from such a legal perspective may differ from what is implied by the contractual terms of the respective instruments. If the priority information is provided purely based on contractual basis without taking into account the effects of laws and regulations, a question arises as to how useful such information would be.

(b) Information will be of limited value as the scope of the proposed disclosure only includes financial instruments and does not include other liabilities such as tax liabilities, pension liabilities and contingent liabilities.

(c) Complication may arise from instruments that have higher priority than ordinary shares on liquidation but are required to be written-off on occurrence of specified trigger event, eg default or a non-viability event. For entities in the financial sector in particular, priority in the event of non-viability or upon resolution would be more relevant.

(d) In response to the potential simplification of disclosing the priority on liquidation of financial instruments issued by a parent company only (an example of potential simplifications suggested in the DP), many users of financial statements said that priority information for a parent company alone will not be useful. They typically have more challenges for obtaining information about subsidiaries rather than the parent company.

26. To address the challenges highlighted in paragraphs 24–25, some respondents made the following suggestions for the Board to consider:

(a) Require disclosure of priority on liquidation on an individual entity basis only. Further scope reduction can be achieved by requiring this disclosure for significant subsidiaries only.

(b) Permit entities to present two financial instruments as if they have the same priority (ie pari passu), if the priority of those two financial instruments is not evident from their contractual terms. This would also assist in ensuring that an entity is not required to make and publicly disclose a judgment that could impair its relationship with a creditor or restrict its ability to negotiate the settlement of a claim.

(c) Consider the pillar 3 disclosure requirements in the BASEL framework as a reference to develop the disclosure proposals further. A few respondents from the banking sector highlighted that the Pillar 3 requirements contain templates for providing information on creditor ranking at legal entity level, from the most junior to the most senior exposures.

(d) Require disclosure of priority on resolution instead of liquidation if that provides more relevant information for a particular entity. Some suggested the Board require disclosure of priority on a going concern basis (which would be influenced by the maturity of financial instruments) as well as on liquidation. Others added that if the Board were to require or allow this disclosure to be prepared on any other basis than of liquidation, clear disclosure of the basis of preparation is important.

Potential dilution of ordinary shares

27. Most respondents agreed that the proposed disclosures would be useful, with some adding that these would be even more important if the Board does not proceed with its proposal for presentation of equity instruments.

28. However, a few respondents disagreed with the proposal for the reasons described below. Similar observations were also made by some respondents who supported the Board's proposal:

(a) While acknowledging that the requirements in IAS 33 have room for improvement, a few respondents noted that determining what the appropriate information is to represent the returns for holders of equity instruments is a complex issue and may better be addressed as a separate research project.

(b) Similar to the comments made on the presentation of equity instruments, they noted that this disclosure would be onerous for non-listed entities which do not currently apply IAS 33. Most respondents who commented about the scope suggested that the scope of this disclosure be restricted to those who apply IAS 33.

29. While agreeing with the Board's proposals, some respondents including users of financial statements, also made suggestions to further improve the usefulness of the disclosure. For example, disclosure of a range of number of shares that may be issued, ie minimum number of shares as well as the maximum number of shares. Users of financial statements in particular said that this disclosure should also be provided for the instruments in scope of IFRS 2 *Share-based Payment* to provide complete information about potential dilution.

Contractual terms and conditions

30. Most respondents agreed with the proposal because they considered the proposed disclosures would:

(a) allow users of financial statements to form their own opinions about classification and to conduct their analysis on that basis. They noted that academic research suggests that users of financial statements hold a variety of opinions about the characteristics of instruments that are most important in determining liabilities and equity.

(b) enable users of financial statements to understand why particular instruments are classified as a financial liability or as an equity instrument.

(c) alleviate the burden on users of financial statements to look into several sources of information other than financial statements such as the prospectus and the analyst reports issued by credit rating agencies to understand the contractual terms of an instrument.

31. However, a few respondents disagreed with the proposed disclosure about terms and conditions because in their view, financial statements are not the best place to provide such information. If information on various instruments were to be

provided at a sufficiently granular level to be useful, it could lead to disclosure overload.

32. Some respondents that disagreed with the proposed disclosures, pointed out that the proposal in the DP reintroduces the disclosure requirements that previously existed in IAS 32 but were removed when IFRS 7 *Financial Instruments: Disclosures* was issued because of disclosure overload concerns. However, an accounting firm noted that the focus of IFRS 7 has been on financial assets and liabilities, not equity instruments and said that they supported re-establishing a balance of information provided about all financial instruments.

33. Many respondents who agreed with the Board's proposal said that disclosure overload should be avoided but at the same time acknowledged that it is a difficult issue to solve as oversimplifying any disclosures provided, is potentially misleading. They suggested the Board consider the following to address this challenge:

    (a) Permit cross-referencing if the information is available elsewhere, eg prospectus or regulatory reporting document such as the pillar 3 disclosures for banks.

    (b) Limit the scope of this disclosure to those financial instruments that the entity uses as part of its capital structure. The capital management disclosures requirements in IAS 1 *Presentation of Financial Statements* could be extended to include this disclosure to avoid duplication.

    (c) Limit the scope of this disclosure to those financial instruments for which classification involves significant judgement, eg using the requirements in IAS 1 about key judgements and estimates.

    (d) Limit the scope of this disclosure to equity instruments and those financial instruments that has characteristics of equity.

    (e) Develop objective-based disclosures rather than prescriptive requirements. Some encouraged the Board to consider the interaction with the Disclosure Initiatives project.

(f) Provide implementation examples to demonstrate how preparers may apply their judgments when evaluating which terms and conditions of financial instruments are material to their financial instruments.

Other information that should be disclosed

34. Some respondents suggested the Board consider requiring disclosure about situations where economic compulsion may exist, for example, equity-classified instruments that are ‘reasonably certain’ to be redeemed in the short term. See Agenda Paper 5C for this meeting for further detail of feedback received on the role of economic compulsion and incentives on the classification of financial instruments.

35. One of the standard-setting body highlighted potential improvements to be made to the disclosures in IAS 1 on restrictions to transfer cash. They noted that many users have mentioned in the past that they often look for information about the nature and extent of any significant restrictions of the entity's ability to transfer funds to its shareholders in the form of cash dividends or any significant restrictions of the entity's ability to repay financial liabilities.