

STAFF PAPER

July 2019

IASB® meeting

Project	Financial Instruments with Characteristics of Equity (FICE)		
Paper topic	Feedback summary—Contractual Terms		
CONTACT(S)	Uni Choi	uchoi@ifrs.org	+44 (0) 20 7246 6933
	Riana Wiesner	rwiesner@ifrs.org	+44 (0) 20 7246 6412

This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board (Board) and does not represent the views of the Board or any individual member of the Board. Comments on the application of IFRS® Standards do not purport to set out acceptable or unacceptable application of IFRS Standards. Technical decisions are made in public and reported in the IASB® *Update*.

Objective

1. This paper summarises the detailed feedback received on Section 8 of the Discussion Paper *Financial Instruments with Characteristics of Equity* (DP). Section 8 of the DP sets out the Board's preliminary views on whether the Board's preferred approach should take into account the effects of economic incentives of the issuer and of laws and regulations in classifying financial instruments as financial liabilities or equity.
2. This paper is structured as follows:
 - (a) Background—proposals and questions in the DP (paragraphs 3–6);
 - (b) Key messages from the feedback received (paragraph 7–10);
 - (c) Economic compulsion and economic incentives (paragraphs 11–22); and
 - (d) The effects of laws and regulations on the contractual rights obligations (paragraphs 23–34).

Background—proposals and questions in the DP

3. In the Board’s preliminary view, economic incentives that might influence the issuer’s decision to exercise its rights should *not* be considered when classifying a financial instrument as a financial liability or equity. Thus, applying the Board’s preferred approach, classification should be based on the rights and obligations established by the contractual terms of a financial instrument including obligations that are established indirectly through the terms of the contract. This is consistent with the current treatment in IAS 32 *Financial Instruments: Presentation*.
4. The Board asked the following questions:

Question 10

Do you agree with the Board’s preliminary view that:

- (a) economic incentives that might influence the issuer’s decision to exercise its rights should not be considered when classifying a financial instrument as a financial liability or an equity instrument?
- (b) the requirements in paragraph 20 of IAS 32 for indirect obligations should be retained?

Why, or why not?

5. In addition, the Board’s preliminary view is that an entity should apply the Board’s preferred approach to the contractual terms of a financial instrument without taking into account the effects of laws and regulations consistently with the existing scope of IAS 32 and IFRS 9 *Financial Instruments*.
6. The Board asked the following questions:

Question 11

The Board’s preliminary view is that an entity shall apply the Board’s preferred approach to the contractual terms of a financial instrument consistently with the existing scope of IAS 32. Do you agree? Why, or why not?

Key messages

7. **Should economic incentives be considered when classifying a financial instrument as a financial liability or an equity instrument?** Most respondents agreed with the Board's preliminary view that economic incentives that might influence the issuer's decision to exercise its rights should not be considered when classifying a financial instrument as a financial liability or an equity instrument.
8. **Should the IAS 32 requirements on indirect obligations should be retained?** Most respondents agreed with the Board's preliminary view that the requirements in paragraph 20 of IAS 32 for indirect obligations should be retained.
9. **Should classification of financial instruments be based on the contractual terms without considering the effects of laws and regulations?** Most respondents agreed with the Board's preliminary view that an entity shall apply the Board's preferred approach to the contractual terms of a financial instrument consistently with the existing scope of IAS 32.
10. In addition, many respondents highlighted practice challenges that exist in these areas and recommended the Board analyse the challenges further and provide clarification or guidance. In fact, regardless of whether respondents agreed or disagreed with the Board's preliminary views set out in the DP, they requested clarification or additional guidance on these areas.

Economic compulsion and economic incentives

11. Regardless of whether they agreed or disagreed with the proposals in the DP, most respondents acknowledged that this is a difficult issue to solve and that there are merits in both sides of the argument, ie for and against taking into account economic incentives¹ in classifying financial instruments as financial liabilities or equity.

¹ As described in paragraph 8.8 of the DP, in some circumstances, economic incentives for an issuer of financial instruments may be so strong that some would view the entity as being 'economically compelled' to exercise a particular settlement outcome. Consistent with the DP, in this Agenda Paper, the term 'economic incentives' includes 'economic compulsion'.

Agreement with the Board's preliminary view

12. Most respondents supported the Board's preliminary view that economic incentives that might influence the issuer's decision to exercise its rights should not be considered when classifying a financial instrument for one or more of the following reasons:
- (a) Considering economic incentives would complicate the classification of financial instruments and result in several challenges as identified by the Board in the DP such as how significant the economic incentives need to be and whether the classification needs to be reassessed as facts and circumstances change economic incentives. Many respondents said that frequent reclassification between equity and liabilities would present significant practice challenges and will not provide useful information.
 - (b) Assessment of economic incentives would often require significant judgement. Consistent application would be challenging leading to diversity in practice and reduced comparability as similar entities may issue similar financial instruments but may classify them differently depending on their view of the economic incentives. Some respondents also noted that classification could be open to manipulation to achieve a specific accounting outcome.
 - (c) It is difficult to determine how far the consideration of economic incentives should be extended. For example, an entity may have a history of regularly making dividend payments on ordinary shares and could be economically compelled to continue meeting shareholders' expectations for making dividend payments. Respondents did not believe economic incentives for an entity to pay dividends on ordinary shares convey an obligation to the entity.
 - (d) The application of IAS 32 with regards to economic incentives is well understood and respondents do not see a compelling reason to change it.

- (e) It is not appropriate to recognise a liability when no contractual obligation exists simply because the entity feels compelled to make a payment which it has the contractual right to avoid.
 - (f) Given the symmetric relationship between the classification by the issuer and by the holder,² it would be more challenging for the holder to determine what the issuer's classification would be considering the issuer's economic incentives.
13. Without disagreeing with the Board's preliminary view, a few respondents emphasised the importance of considering economic incentives for banking regulatory purposes. They highlighted that under the BASEL III framework, a financial instrument is not eligible to be classified as Additional Tier 1 capital instruments if it includes any incentives for the issuer to redeem the instruments. A few respondents observed that the introduction of such a requirement in the BASEL framework means that the number of issuances of financial instruments that contain economic incentives by design has reduced for the banking sector.
14. With regards to indirect obligations, most respondents agreed with the Board's preliminary view that the requirements in paragraph 20 of IAS 32 should be retained. The main reason provided by them was that the requirement helps reduce structuring opportunities. However, many respondents, including those who agreed, also said that further improvements in this area are required and could be made in the way described in paragraph 19 of this agenda paper.
15. On the other hand, a few respondents who agreed that economic incentives should *not* be considered when classifying an instrument as a financial liability or equity, disagreed with retaining the indirect obligation requirements in paragraph 20 of IAS 32. This was mainly because they saw the requirement as a way to reflect economic incentives in the classification of financial instruments, which they do not agree with.

² IFRS 9 refers to the definition of equity instruments in IAS 32.

Disagreement with the Board's preliminary view

16. Some respondents who provided feedback on this topic disagreed with the proposals in the DP. These respondents believe economic incentives should be considered in classification of financial instruments because such an approach would lead to a better depiction of the economic substance of financial instruments. Some of them expressed the view that other IFRS Standards require consideration of economic incentives in accounting. For example:
- (a) constructive obligations as defined by IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* would include obligations that arise because an entity does not have a realistic economic alternative to settle the obligation.
 - (b) IFRS 15 *Revenue from Contracts with Customers* requires consideration of the customer's economic incentive, if an entity has an obligation to repurchase from a customer an asset at a price that is lower than the original selling price of the asset.
17. A few of the respondents who disagreed with the Board's preliminary view said that only economic compulsion (not merely incentives) should affect classification and they believed this can be achieved using the concept of 'no practical ability to avoid' in the *Conceptual Framework for Financial Reporting* (Conceptual Framework).
18. Both the Brazilian securities regulator and standard-setting body consider the proposals in the DP to introduce a change from the requirements in IAS 32. This is because paragraph 15 of IAS 32 requires financial instruments to be classified in accordance with the substance of the contractual arrangement. In their view, consideration of economic incentives is necessary to determine the substance of the contractual arrangements.

Suggestions for the Board

Improvements to IAS 32

19. Many respondents, including those who agreed and those who did not agree with the Board's preliminary view, suggested that the Board could make the following improvements or clarifications with regards to economic incentives and indirect obligations regardless of whether the Board proceeds with the proposals in the DP or not:
- (a) Develop disclosure requirements about the contractual terms and the associated economic incentives, for example, whether economic compulsion exists, or the likelihood of share or cash settlement based on the conditions on the reporting date.
 - (b) Clarify the principle supporting the requirements for indirect obligations as some respondents consider the example in paragraph 20(b) of IAS 32 to provide structuring opportunities. Clarifying the principle would also assist in resolving the perceived inconsistency in IAS 32 between the requirements for indirect obligations (in paragraph 20) and contingent settlement provisions (in paragraph 25) noted by some respondents. In their view, for a financial instrument to be classified as equity:
 - (i) in accordance with paragraph 20, the equity-settlement should be preferable to the cash-settlement alternative in some genuine scenarios or the value of the equity-settlement should not substantially exceed the value of the cash-settlement; whereas
 - (ii) in accordance with paragraph 25, the issuer should have the ability to avoid paying cash in all genuine scenarios.
 - (c) Develop guidance that helps distinguish economic incentives from indirect obligation.
 - (d) Develop guidance for assessing the substance of the contractual terms, an issuer's option, in particular. Guidance on substantive settlement

options consistent with the January 2014 agenda decision by the IFRS Interpretations Committee would be helpful.³

- (e) Incorporate the notion of ‘no commercial substance’ in IFRS 2 *Share-based Payment* to reinforce the principle in paragraph 15 of IAS 32.⁴ Respondents expressed the view that before applying classification requirements, an entity should first consider whether one of the settlement alternatives:
 - (i) has no economic substance (e.g. equity settlement outcome is structured in such a way that its value would always exceed the liability settlement outcome); or
 - (ii) has no commercial substance (e.g. the entity is legally prohibited from issuing shares).
- (f) Explicitly state the role of economic incentives per the Board’s preliminary view in the DP because, in a few respondents’ views, IAS 32 does not have a clear principle in this regard.

20. A few respondents acknowledged that the ‘amount’ feature of the Board’s preferred approach to classification addresses some of the issues relating to economic compulsion, for example the classification of financial instruments with interest ‘step-up’ features. These respondents were however not supportive of the amount feature proposed in the DP for the various reasons summarised in [Agenda Paper 5A for the June 2019 Board meeting](#).

Interactions with other Standards

21. Some respondents, including some of those who agreed with the Board’s preliminary views in the DP, suggested the Board consider exploring ways to reflect economic compulsion or economic incentives in classification of financial instruments because

³ [The agenda decision](#) related to an instrument that was mandatorily convertible into a variable number of shares with an option exercisable by the issuer to settle in a fixed number of shares.

⁴ Paragraph 15 of IAS 32 states that the issuer of a financial instrument shall 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.

they believed doing so better depicts the economic substance of an instrument. They recognised that it is a highly complex issue and hence encouraged the Board to undertake a separate longer-term project to explore this area. The following concepts and definitions were suggested as a possible starting point for the Board:

- (a) ‘No practical ability to avoid’ in the Conceptual Framework;⁵
- (b) ‘Constructive obligation’ and ‘more likely than not’ in IAS 37; and
- (c) ‘No commercial substance’ or ‘a past practice or a stated policy of setting in cash’ in IFRS 2.

22. Many other respondents also commented specifically on the interaction of the Board’s preliminary views relating to economic incentives and classification with the concept of ‘no practical ability to avoid transferring an economic resource’ in paragraph 4.34 of the Conceptual Framework. However, they expressed a wide range of different views as to what the Board should do about it, which included:

- (a) Clarify the interaction and explain why a different approach is taken for classification of financial instruments;
- (b) Consider developing an alternative using the Conceptual Framework as a starting point. Consistent with the feedback discussed in Agenda Paper 5A for the June 2019 Board meeting, some of these respondents recommended the Board use the Conceptual Framework as the starting point for building a principle for distinguishing liabilities from equity more broadly (ie not limited to addressing economic compulsion issue).
- (c) Proceed with the preliminary views set out in Section 8 of the DP. Respondents acknowledged that preliminary views in the DP on economic incentives are different from the Conceptual Framework, but they prefer the Board’s approach for reasons similar to what the Board provided in Section 8 of the DP.

⁵ See Appendix A of this agenda paper for relevant paragraphs referred to by respondents.

The effects of laws and regulations on the contractual rights and obligations

23. Most respondents agreed that the Board's preferred approach set out in the DP should be applied to the contractual terms of a financial instrument, without taking into account the effects of laws and regulations consistently with the current treatment in IAS 32 and IFRS 9. Some respondents said that reflecting the effects of laws and regulations in classification would require significant effort in analysing and continuously monitoring the effect of laws and changes thereof in classifying financial instruments.
24. On the other hand, some respondents disagreed with the Board's preliminary view for one or more of the following reasons:
- (a) There is little difference between contractual obligations and legal obligations in terms of economic effects. Focusing only on the contractual obligations leads to a risk that the substance of transactions is not fully captured.
 - (b) Contractual terms incorporate either directly or indirectly the provisions of applicable laws and regulations, and they cannot be considered independently of the legal environment. The enforceability of contractual terms depends on law. Furthermore, legal requirements can limit or otherwise affect the rights and obligations arising from the contract.
 - (c) Inconsistency between the Board's preliminary views and approaches taken by other IFRS Standards and the Conceptual Framework (see Appendix A of this agenda paper).
25. Furthermore, a few respondents made comments that are specific to their jurisdiction or a particular industry to explain why they think consideration of the effects of laws and regulations is important when classifying financial instruments, for example:
- (a) from an Islamic banking perspective, legal requirements are important factors in determining the overall classification of any financial instrument and expressed a view that the current requirement in IAS 32 to only consider the contractual terms can be arbitrary.

- (b) Consideration of the effects of law is particularly important for entities in particular industries, for example the oil and gas industry that have financial liabilities arising from agreements with governments and therefore are subject not only to the terms of the financial contract itself, but also to obligations arising from legislation.

Request for the Board to address practice challenges

26. Regardless of whether or not respondents agreed or disagreed with the Board's preliminary views, most respondents said that differentiating between contractual and statutory obligations is challenging in practice and requested the Board provide additional guidance or clarification on a number of practice issues that are summarised in paragraphs 27–31.
27. Specifically, many respondents said that entities currently face challenges when determining whether the relevant legal requirements are part of the contractual terms of a financial instrument if a contract refers to or reproduces such legal requirements, and suggested the Board clarify how to differentiate between contractual obligations and legal obligations in this regard. It was observed that classification should not depend on whether or not an entity chooses to incorporate the legal requirements in the contracts. Many of these respondents expressed one of the following views:
- (a) legal requirements that are referred to or reproduced should *not* be considered as part of the contractual terms. Only those contractual terms that establishes rights and obligations beyond the legal rights and obligations should be considered in classifying financial instruments.
 - (b) similar to paragraph (a) but that legal requirements referred to or reproduced in the contract should *not* be considered as part of the contractual terms *only* to the extent that the contract is designed in such a way that it would always reflect the *current* legal requirements. For example, if the legal requirements change, the contract will also automatically change. In such a case, the legal requirements referred to in the contract would not affect classification.

- (c) Legal rights and obligation that applies to a contract would always be considered in determining classification of financial instruments regardless of whether the legal rights or obligations are written in the contract.
28. In addition to the challenge mentioned in paragraph 27, a few respondents also raised a question about whether the legal power of a statutory body should affect the classification of a financial instrument, for example, when the contract gives the relevant regulator the power to determine when an entity is considered non-viable and how the loss absorption mechanism works in such an event. One of the most common examples used to describe these challenges was financial instruments that include non-viability clauses. Financial regulations require these financial instruments to be subject to a mechanism that could impose losses on the instrument holders upon the occurrence of a specified event such as the deterioration of the issuer's regulatory capital position below a specific threshold or determination by a relevant regulator that the issuer is non-viable.
29. Other examples highlighted by respondents to demonstrate the challenges encountered in practice include the following:
- (a) Mandatory tender offers;
 - (b) Legal requirements that mandate a payment on financial instruments, for example a minimum dividend payment required on ordinary shares in some jurisdictions; and
 - (c) Contracts for some financial instruments that may be thinly drafted because statute provides default terms. For example in the UK, it is not legally required to have contractual terms for ordinary shares, but the default is that the terms are set by statute (ie terms in the memorandum and articles). Similarly, in many other jurisdictions, the terms of ordinary shares are based on statutory requirements.
30. A few respondents specifically encouraged the Board to clarify the accounting for mandatory tender offers. Some added that a liability should be recognised and its accounting should be similar to that of a put option written on non-controlling interest

because they both constitute an obligation to purchase a subsidiary's shares. However, one standard-setting body specifically mentioned that they do not support the Board providing specific guidance on, or an exception for, mandatory tender offers unless the Board can identify why mandatory tender offers are sufficiently different from other legal requirements to justify an exception.

31. A few respondents also highlighted that should the Board's preferred approach to classification (as discussed in Agenda Paper 5A for the June 2019 Board meeting) be implemented, further challenges in this regard could arise, including:
 - (a) Assessment of the 'amount' feature— the principles proposed in the DP requires assessment of the amount of an entity's obligations at liquidation. In many jurisdictions, procedures on liquidation are driven by statute or regulation rather than contractual terms. It is therefore unclear whether, when analysing an entity's obligations at liquidation, statutory requirements should be ignored.
 - (b) The interaction between the Board's preferred approach and the requirements in IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* should be clarified (See [Agenda Paper 5E for the June 2019 Board meeting](#)).

Suggestions for the Board

32. In making suggestions to the Board on how to address the challenge regarding legal and statutory requirements, a few respondents suggested that classification of financial instruments as financial liabilities or equity instruments should start with the terms and conditions stipulated in the contract, but the entity should also consider laws and regulations that clarify, limit or explain the rights and obligations arising from the contract. Applying this approach, a pure legal obligation, ie no contract exists between two parties, would not be a financial instrument.
33. One accounting firm added that they acknowledge the approach described in paragraph 32 may have unintended consequences for some financial instruments such as ordinary shares subject to a statutory obligation to distribute profit. However, they

suggested that this concern could be addressed by allowing these instruments to meet the definition of equity if particular conditions similar to the puttable exception in IAS 32 are met. Another potential unintended consequence would be that some financial instruments that are legally puttable that are classified as equity instruments applying IAS 32 could be classified as financial liabilities. The respondent suggested the effects of the liability classification could be mitigated by reflecting probability of the exercise of those rights in the measurement of such instruments. In their view, such probability is very low and hence would result in a liability of an insignificant value.

34. While acknowledging challenges that would arise if the effects of law were to be factored into classifying financial instruments, many respondents highlighted that many IFRS Standards already takes into account such effects (Appendix A to this paper shows paragraphs referred to by respondents). Some of them also pointed out that the Conceptual Framework states that obligations can be established by legislation as well as contract. They suggested the Board consider whether a similar concept could be applied to financial instruments.

Appendix A—Paragraphs extracted from other IFRS standards and the Conceptual Framework

The Conceptual Framework for Financial Reporting

- 4.29 An obligation is a duty or responsibility that an entity has no practical ability to avoid. An obligation is always owed to another party (or parties). The other party (or parties) could be a person or another entity, a group of people or other entities, or society at large. It is not necessary to know the identity of the party (or parties) to whom the obligation is owed.
- 4.31 Many obligations are established by contract, legislation or similar means and are legally enforceable by the party (or parties) to whom they are owed. Obligations can also arise, however, from an entity's customary practices, published policies or specific statements if the entity has no practical ability to act in a manner inconsistent with those practices, policies or statements. The obligation that arises in such situations is sometimes referred to as a 'constructive obligation'.
- 4.34 The factors used to assess whether an entity has the practical ability to avoid transferring an economic resource may depend on the nature of the entity's duty or responsibility. For example, in some cases, an entity may have no practical ability to avoid a transfer if any action that it could take to avoid the transfer would have economic consequences significantly more adverse than the transfer itself. However, neither an intention to make a transfer, nor a high likelihood of a transfer, is sufficient reason for concluding that the entity has no practical ability to avoid a transfer.

IAS 37 – Provisions, Contingent Liabilities and Contingent Assets

- 10 [...] A legal obligation is an obligation that derives from:
- a contract (through its explicit or implicit terms);
 - legislation; or
 - other operation of law.
- [...]

IAS 38 – Intangible Assets

- 13 An entity controls an asset if the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits. The capacity of an entity to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. In the absence of legal rights, it is more difficult to demonstrate control. However, legal enforceability of a right is not a necessary condition for control because an entity may be able to control the future economic benefits in some other way.

IFRS 15 – Revenue from Contracts with Customers

- 10 A contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral or implied by an entity's customary business practices. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries and entities. In addition, they may vary within an entity (for example, they may depend on the class of customer or the nature of the promised goods or services). An entity shall consider those practices and processes in determining whether and when an agreement with a customer creates enforceable rights and obligations.

IFRS 17 – Insurance Contracts

- 2 An entity shall consider its substantive rights and obligations, whether they arise from a contract, law or regulation, when applying IFRS 17. A contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral or implied by an entity's customary business practices. Contractual terms include all terms in a contract, explicit or implied, but an entity shall disregard terms that have no commercial substance (ie no discernible effect on the economics of the contract). Implied terms in a contract include those imposed by law or regulation. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries and entities. In addition, they may vary within an entity (for example, they may depend on the class of customer or the nature of the promised goods or services).

IFRIC 2 – Members' Shares in Co-operative Entities and Similar Instruments

- 5 The contractual right of the holder of a financial instrument (including members' shares in co-operative entities) to request redemption does not, in itself, require that financial instrument to be classified as a financial liability. Rather, the entity must consider all of the terms and conditions of the financial instrument in determining its classification as a financial liability or equity. Those terms and conditions include relevant local laws, regulations and the entity's governing charter in effect at the date of classification, but not expected future amendments to those laws, regulations or charter.
- 8 Local law, regulation or the entity's governing charter can impose various types of prohibitions on the redemption of members' shares, eg unconditional prohibitions or prohibitions based on liquidity criteria. If redemption is unconditionally prohibited by local law, regulation or the entity's governing charter, members' shares are equity. However, provisions in local law, regulation or the entity's governing charter that prohibit redemption only if conditions—such as liquidity constraints—are met (or are not met) do not result in members' shares being equity.