IFRS® Foundation

Financial Instruments with Characteristics of Equity: Potential disclosure refinements

Accounting Standards Advisory Forum meeting

ASAF Agenda Paper 3

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Purpose of this session

Seeking feedback from ASAF members on potential refinements to disclosures proposed in the 2018 Discussion Paper (DP). Questions for ASAF members are set out in slides 9, 14 and 20.

This paper provides an update on the disclosures part of the FICE project and for each type of disclosure proposed in the 2018 DP highlights:

- Challenges raised in the feedback
- Potential refinements to proposals (slides 6, 12 and 17)
- Feedback from investors (slides 8, 13 and 19)

Appendix slides (for additional information purposes only)

Please note the potential refinements discussed in this pack are preliminary ideas of the staff and will be subject to the Board's decisions in the future. The Board may decide on disclosure requirements that differ from the refinements presented. The feedback provided will help shape the disclosure proposals that will be presented to the Board at a future meeting.

FICE—project overview

- Project objective
  - improve the information that entities provide in their financial statements about financial instruments that they have issued
  - address challenges with applying IAS 32 *Financial Instruments: Presentation*
- Project update—disclosures

June 2018	H1 2019	H2 2019-Q1 2020	Q2-Q4 2020	Next steps
Discussion Paper published with 180-day comment period	Feedback analysis: Overall support for disclosures from stakeholders, especially investors with challenges highlighted	Staff developed potential refinements after considering feedback on the DP	Outreach with stakeholders about the potential refinements	The Board will discuss enhanced disclosure proposals taking into account feedback from stakeholders

Information about Priority on liquidation

IFRS

2018 DP disclosure proposal

Provide information on the face of statement of financial position or in the notes such as:

- List of all material financial liabilities and equity instruments in the order of their priority
- Terms and conditions that indicate priority within the entity's capital structure
- Terms and conditions that could lead to changes in priority on liquidation
- Terms and conditions that indicate promised returns
- Reason for any changes in the priority of any group of financial instruments

Challenges raised in the feedback:

- Concerns over providing disclosure on a consolidated basis
- Carrying amounts preferred to fair values
- Disclosure in the notes preferred
- Can be misleading if non-financial instruments (eg tax payables) are excluded
- Unlikely to reflect balance sheet at liquidation
- Regulators in specific industries require similar but slightly different information

Potential refinements to proposals

The staff are exploring the following refinements:

- **Priority information disclosed by individual entity** for the parent and each subsidiary that has issued material financial instruments **with a reconciliation** to the group consolidated amounts
- Disclose **carrying amounts** of financial liabilities and equity instruments in the **notes** to the financial statements showing the order of priority on liquidation **based on contractual terms** and **qualitative information** about contractual terms and conditions that affect the priority
- If an entity is subject to regulation that specifies a **resolution process (eg a bank)**, either before or instead of, liquidation, provide information about priority on that basis
- If relevant, disclose the fact that the **legal priority of claims on liquidation differs** from the priority purely based on the contractual terms. Provide a narrative description, to the extent possible, of the effect of the legal view of priority on liquidation
- Provide a narrative description, to the extent possible, of the effect of **non-financial liabilities and financial instruments which are scoped out of IAS 32** on the order of priority on liquidation
- Disclose details of any parent-subsidiary guarantee or other **intra-group arrangements** that might impact priority on liquidation

Example of potential disclosure refinements

- The following table shows priority of financial instruments on liquidation of each individual entity based on contractual terms of the instruments, disclosed in the notes to the consolidated financial statements.

Order of priority on liquidation	Company X (Parent)	Subsidiary A	Subsidiary B	Other group entities and amounts eliminated on consolidation	Consolidated
	Carrying amount at reporting date (£'000)				
Trade payables	500	2,200	120	55	2,875
Bank loans	-	1,000	750	200	1,950
Medium-term notes	2,000	3,000	-	-	5,000
Perpetual bonds	3,500	5,000	-	-	8,500
Preference shares	2,000	-	-	-	2,000
Ordinary shares	15,000	10,000	7,000	(17,000)	15,000

- Entities within the group also have other liabilities that are not presented in the table, which are required to be settled in liquidation. They include tax liabilities and employee benefits. Tax and employee benefits are generally required to be settled prior to settlement of financial liabilities included in the table above.
- The order of priority in the event of liquidation is subject to bankruptcy law of the relevant jurisdiction. The actual order of payments may also be subject to negotiations amongst creditors, and may differ from contractual priority.
- The perpetual bonds issued by subsidiary A are guaranteed by Company X.

What did we hear from investors thus far?

Very important to see the priority order and ranking of all instruments to assess the quality of capital on an entity level.

Narrative information is helpful eg for tax liabilities or legal participation.

Prefer carrying amounts rather than fair values.

Some narrative information may create more questions than being helpful and may not be material in large institutions.

Question 1 for ASAF members

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Do you have any comments about the potential disclosure refinements for information about priority on liquidation?

In particular:

- If the order of priority on liquidation is based purely on the contractual terms of financial liabilities and equity instruments, what do you think about disclosing the following narrative information as a simplification:
  - how legal priority on liquidation differs from contractual priority and
  - how non-financial and other liabilities eg tax liabilities and employee benefits may impact the order of priority on liquidation?
- Because carrying amounts may differ from liquidation recoverable amounts or fair values
  - should quantitative information be provided at all and
  - if so, should the measurement basis be specified?

Information about Potential dilution

2018 DP disclosure proposal

- A list of all financial instruments that could dilute the ordinary shares ie instruments that may be settled in own shares
- Shows maximum number* of ordinary shares an entity may need to deliver to settle such financial instruments outstanding at the reporting date, eg assuming all convertible bonds will be converted into shares
- A reconciliation of movement during the period
- Terms and conditions eg date of share settlement, number of shares to be delivered

Challenges raised in the feedback:

- Concerns over complexity of a reconciliation
- Overlap with IAS 33 *Earnings per share*—some information already captured in diluted earnings per share. The proposed disclosures could be onerous for non-listed entities
- Consider if contracts with potential share redemptions or repurchases should also be included
- To be complete, include instruments in the scope of IFRS 2 *Share-based Payment* and disclose minimum potential dilution

* The maximum number is not the same as the number used in the diluted EPS calculations because it takes into account <u>all</u> potential increases in the number of issued ordinary shares rather than those essentially 'in the money' like IAS 33.

Potential refinements to proposals

The staff are exploring the following refinements:

- For both **listed and unlisted** entities provide:
  - **Instead of a reconciliation** of changes during the reporting period (see slide 28 in the Appendix), disclose the **maximum number of additional ordinary shares that could be issued** for each type of potential ordinary shares outstanding **at the reporting date**
  - A **narrative explanation of any significant changes** in the maximum number
  - A **narrative description of the instruments** accounted for under IFRS 2, eg employee share options. Relevant IFRS 2 information could be cross referenced.
  - Information about the **key terms and conditions** relevant to understanding potential dilution such as strike price, exercise date and any conditions for exercise.

What did we hear from investors thus far?

Important to understand the maximum number of shares and assumptions as information in practice is currently limited. Disclosing a minimum number is less informative.

Disclosure is more important for unlisted entities than for listed entities because they have very complicated capital structures with many participating instruments.

EPS is a governance issue so other information such as where the dilution risk comes from and how long the risk exists would be more relevant.

Disclosing number of shares subject to potential redemption would be helpful but it would be more helpful to disclose that there is a buyback programme and any restrictions on buying back.

Question 2 for ASAF members

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Do you have any comments about the potential disclosure refinements for potential dilution?

In particular:

- What do you think about the potential simplification of including a narrative description of equity-settled share-based payments with cross reference to IFRS 2 disclosures (ie excluded from calculation of maximum number of additional shares)?
- Should the disclosures be provided by both listed and unlisted entities?

Information about Terms and conditions

2018 DP disclosure proposal

- Applies to financial liabilities and equity instruments
- Terms and conditions that are relevant to determining the timing and amount of cash flows of a financial instrument
    - For example, if the issuer has an option to redeem an instrument earlier than its maturity, the timing and the amount of the redemption and if it depends on a trigger event, the description of that event

Challenges raised in the feedback:

- Concern about 'disclosure overload' especially for multinationals or regulated entities (cross referencing to publicly available information should be allowed)
- When financial instruments have many features, it is often difficult to understand what the key features are that lead to the classification of equity or liability
- Investors are primarily interested in understanding future cash flows of the entity and voting rights

Potential refinements to proposals

The staff are exploring the following refinements:

- Disclose in a **single note** to the financial statements:
  - For **all capital instruments issued for longer-term funding**, the key terms and conditions that affect **the nature**, **timing, amount and uncertainty of future cash flows**. For example: conditions that trigger early redemption or refinancing in cash or conversion into ordinary shares, step-up clauses, terms that allow an entity to defer the payment of interest and information about covenants associated with outstanding claims.
  - For instruments **where classification involves significant judgement** because instruments have characteristics of both equity and debt, disclose the **key features** (including assumptions and judgements) that led to the classification.
  - Disclose information about **any voting rights**. If the voting right is only exercisable in specified circumstances, describe those circumstances.
- Can be provided in **a tabular format** ie a table of key terms with one line per type of instrument.

Simplified example

- Company X issues a perpetual bond. Key terms and conditions that affect its cash flows are as follows:

Nature	Timing	Amount	Uncertainty
Coupon	Semi-annually	5% per annum	Company X may defer interest payment at its discretion. Any deferred amounts accumulate and are added to the amount payable at the earlier of the redemption of the instrument or at the liquidation of Company X.
Principal repayment	Contractually due at the liquidation of Company A	Par value of £1 million if paid at liquidation of the entity	Company X holds a call option that can be exercised at the fifth anniversary after the issuance of the instrument. If called, the instrument is redeemable at 101% of the par value plus any unpaid and accumulated interest.

The perpetual bond carries no rights of conversion into ordinary shares of Company X and no right to attend or vote at shareholder meetings of Company X.

The perpetual bond is classified as an equity instrument because the issuer has no contractual obligation to deliver cash or another financial asset in any circumstances outside its control, except in the event of the liquidation of Company X.

What did we hear from investors thus far?

Generally supportive of disclosures and particularly, the key features that led to classification for complex financial instruments.

Very helpful to know when potential cash flows take place especially for companies in financial trouble.

Large financial institutions would need to make a lot of disclosure and regulatory disclosures are already required but a summary of terms is helpful.

Disclosure of voting rights is important.

Question 3 for ASAF members

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Do you have any comments about the potential disclosure refinements for terms and conditions?

In particular:

- do you think the scope of these disclosures should be limited only to instruments **where classification involves significant judgement** because instruments have characteristics of both equity and debt?

Appendix

For information purposes

Existing IAS 33 requirements - Summary

- IAS 33 applies to listed entities – separate and consolidated financial statements (if parent is listed).
- IAS 33 requires the calculation of diluted earnings per share (DEPS) to provide a measure of the interest of each ordinary share in the performance of an entity while giving effect to all dilutive potential ordinary shares outstanding during the period. Potential ordinary shares are weighted for the period they are outstanding.
- Potential ordinary shares are treated as dilutive when and only when their conversion to ordinary shares would decrease EPS or increase loss per share.
- To maximise the dilution of basic earnings per share, each issue or series of potential ordinary shares is considered in sequence from the most dilutive to the least dilutive.
- When more than one basis of conversion exists, the calculation assumes the most advantageous conversion rate or exercise price from the standpoint of the holder of the potential ordinary shares.
- For the purpose of calculating DEPS, an entity shall assume the exercise of dilutive options and warrants of the entity. Options and warrants have a dilutive effect only when they are 'in the money'.

Existing IAS 33 requirements – Summary (cont.)

- The number of contingently issuable shares included in the DEPS calculation is based on the number of shares that would be issuable if the end of the period were the end of the contingency period. If the condition is not satisfied based on this assumption, the instrument is considered as not dilutive. If the number of ordinary shares contingently issuable depends on the future market price of the ordinary shares, the calculation of DEPS is based on the number of ordinary shares that would be issued if the market price at the end of the reporting period were the market price at the end of the contingency period.
- When an entity has the option to settle a contract in shares or cash, the entity shall presume that the contract will be settled in ordinary shares, and the resulting potential ordinary shares shall be included in DEPS if the effect is dilutive. Where the choice of settlement is at the holder's option, the more dilutive of cash settlement and share settlement shall be used in calculating DEPS.
- Contracts such as purchased put options and purchased call options are not included in the calculation of DEPS because including them would be antidilutive.
- Contracts that require the entity to repurchase its own shares, such as written put options and forward purchase contracts, are reflected in the calculation of DEPS if the effect is dilutive.

Calculation of maximum number

- In calculating the maximum number, the following will be required (different from diluted EPS calculation):
  - No weighting of the maximum number of additional shares for the period outstanding.
  - For written call options and warrants, use the number of shares that would be delivered upon exercise, not the bonus element.
  - Include anti-dilutive instruments that could become dilutive in future
  - For financial instruments where settlement in shares or the number of shares depends on a contingent event, assume the contingency is met.
  - For forward contracts to buy back shares and written put options, use the number of shares that will or could be bought back (not the bonus element) to reduce the maximum number.
  - If an instrument gives either party an option to settle in cash or shares, assume share settlement.

Simplified example

- The following table illustrates how the maximum number of additional ordinary shares will be calculated for disclosure purposes. The maximum number is expected to be disclosed together with key terms and conditions that are relevant to understanding the potential dilution.

Instruments	Amt (£)	Conversion ratio	Other features	Maximum number of additional ordinary shares to be disclosed
Convertible bond A	2,000	£9/share	In the event of a change of control of the issuer, the conversion ratio is adjusted to £8/share	250 (assume change of control occurs)
Convertible bond B	3,000	£12/share	Anti-dilutive (interest (net of tax and other changes in income or expense) per ordinary share obtainable on conversion exceeds basic EPS)	250 (include anti-dilutive options)
Convertible bond C	5,000	£15/share	Issuer holds an option to settle in cash or shares, if converted by holder	350 (assume settled in shares)

Simplified example (cont.)

Instruments	Amt (£)	Conversion/ Settlement ratio or Exercise/Settlement price	Other features	Maximum
Contingently convertible	1,000	£20/share	Conversion contingent on the occurrence of a non-viability event	50 (assume a non-viability event occurs)
Share-settled bond	500	As many shares as are worth £500 on settlement date		50 (based on the reporting date share price of £10) Or unlimited (unlisted entity)
Share buy-back	commitment	Market value	Commitment to buy min 100 – max 500	(100) (assume minimum bought back)
Mandatorily convertible note	1,000	as many shares as are worth £1K	Subject to a cap of 100 shares and a floor of 10 shares	100

Note: some obligations arising from share-based payments will or may be settled by delivering ordinary shares. For further detail, please refer to note [x] of the financial statements.

Simple illustration of reconciliation of maximum number of ordinary shares

- Reconciliation of changes during the period in the number of:
  a) ordinary shares outstanding and
  b) the maximum number of ordinary shares that could potentially be issued
- To be provided in the notes

		Ordinary shares outstanding	Maximum number of additional ordinary shares
01-Jan-19	**Opening balance**	**5,000,000**	**900,000**
01-Jan-19	Issue of warrants	-	600,000
01-Mar-19	Issue of ordinary shares for cash	200,000	-
30-Jun-19	Conversion of convertible bonds	20,000	(20,000)
01-Sep-19	Exercise of warrants	400,000	(400,000)
31-Dec-19	**Closing balance**	**5,620,000**	**1,080,000**

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