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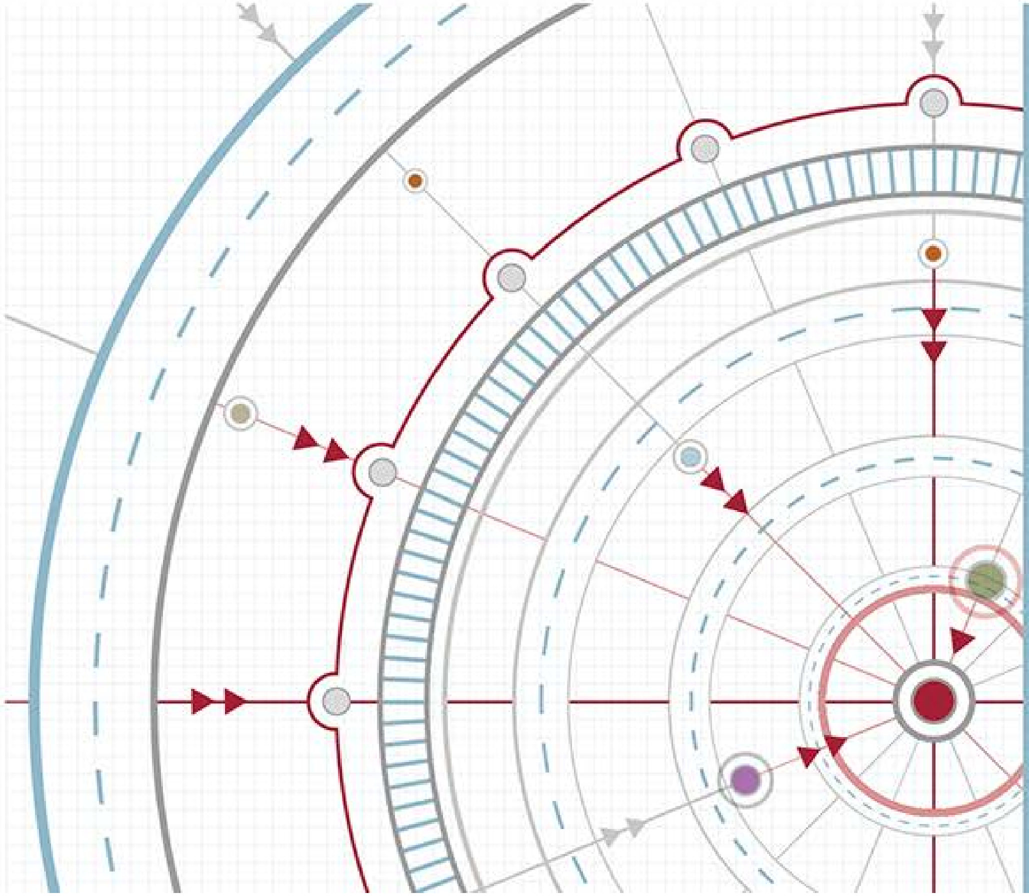

Agenda Paper 2

Disclosure issues
Financial Instruments with Characteristics of Equity

Capital Markets Advisory Committee – March 2020

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Purpose of this session

- The staff will briefly recap the feedback received on the disclosure proposals in the Discussion Paper *Financial Instruments with Characteristics of Equity (FICE)* published in 2018, and provide an overview of how the staff might address those challenges.
- Please note the potential refinements presented in this pack are preliminary ideas of the staff and will be subject to the Board’s decisions in the future.
- The feedback provided by CMAC members will help shape the disclosure proposals that will be presented to the Board at future meetings.
- CMAC members will be given the opportunity to ask any clarifying questions regarding the potential refinements.
- In addition, the staff will seek preliminary feedback from CMAC members on the potential refinements. For this purpose, we have set out specific questions on slides 11, 19 and 24 of this pack.
- The staff expect to continue the discussion on FICE with CMAC in 2020.

Background

- The Board published a Discussion Paper in 2018 and obtained feedback from stakeholders.
- In H2 2019, the Board requested that staff obtain further stakeholder views on potential disclosures and equity investor views about classification of particular perpetual (hybrid) instruments.
- The topic of discussion at this session, is intended to support this research.

2018 DP proposals—disclosure

Priority on liquidation	• Priority of all financial liabilities and equity instruments on liquidation of the entity
Potential dilution of ordinary shares	• Applies to financial 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	• 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

Feedback: Overall support from a broad range of stakeholders, especially from investors. However, some challenges were highlighted

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Potential disclosure objective

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Potential disclosure objective

- To provide users of financial statements with information that enables them to:
  - understand the nature, amount, timing and uncertainty of future cash flows of the entity available to holders of financial instruments to assist in their investment decision-making; and
  - assess potential changes to the entity's capital structure and how the holders of a particular financial instrument may be affected by those changes.
- Disclosures would be useful if:
  a) information is not duplicated in the financial statements,
  b) information is provided at an appropriate level of aggregation or disaggregation and
  c) judgements made in preparing information are provided.

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Information about Priority on liquidation

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Challenges raised in the 2018 DP feedback

Key messages we heard from investors and other stakeholders were:

- Concerns over providing disclosure on a consolidated basis:
  - level of priority is specific to individual entities. Presenting this disclosure on a consolidated basis can be complex in large groups with multiple subsidiaries, especially so if they are in different legal jurisdictions. Added complexity if there are intragroup guarantees and similar arrangements.
  - implicitly assumes a winding up of the entire group in a liquidation waterfall scenario — if a group was in financial distress, more likely that claims would not be settled by liquidating group entities but by disposing of them.
- Carrying amounts preferred to fair values as this can be linked back to financial statements.
- Disclosure in the notes preferred — information on liquidation on the face of statement of financial position inconsistent with going concern basis.
- Can be misleading if non-financial instruments (eg tax payables) are excluded from the disclosure
- Unlikely to be reflective of the balance sheet at the point of liquidation because in the event of liquidation, the entity may have a different capital structure.
- Regulators in specific industries require similar information but in a slightly different manner — additional cost of preparing the information with limited benefit.

Potential disclosure refinements to the DP proposals

To address the challenges summarised on slide 8, the staff are exploring the following refinements:

- For the **parent and each subsidiary that is material to the group**, provide a list of financial liabilities and equity instruments (in the scope of IAS 32) with quantitative information (**carrying amounts**) 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**, 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 have an impact on priority of financial instruments 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, which may be disclosed in the notes to the consolidated financial statements.

Order of priority on liquidation	Company X (Parent)	Subsidiary A	Subsidiary B
	Carrying amount at reporting date (£'000)		
Trade payables	500	2,200	120
Bank loans	-	1,000	750
Medium-term notes	2,000	3,000	-
Perpetual bonds	3,500	5,000	-
Preference shares	2,000	-	-
Ordinary shares	15,000	10,000	7,000

- 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.

Questions for CMAC members

1. Would the potential disclosure refinements provide useful information for users of consolidated financial statements? If yes, for what purpose would you use this information? In particular, would it be useful:
   a) if it is provided on an individual entity level (ie on liquidation of that particular entity) and only for the parent and each material subsidiary in the consolidated accounts?
   b) if the order of priority disclosed is based purely on the contractual terms?
   c) if the fact (where applicable) that the legal priority on liquidation differs from the priority purely based on the contractual terms and the effect this has on contractual priority are disclosed ?
   d) if a narrative description is included of how non-financial liabilities and financial liabilities scoped out of IAS 32 may impact the order of priority on liquidation?
   e) to provide quantitative information (ie the carrying value) considering that on liquidation the recovery values may be more important and bearing in mind that providing recovery or fair values present significant challenges themselves?

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Information about Potential dilution

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Challenges raised in the 2018 DP feedback

Key messages we heard from stakeholders including investors were:

- Concerns over complexity of a reconciliation—the reconciliation of the movement in the maximum number of additional potential ordinary shares during the period is too complex and may be difficult to implement in a large, complex entity resulting in information that is difficult for users of the financial statements to understand.
- Overlap with IAS 33 *Earnings per share*—some information already partly covered by IAS 33 for diluted earnings per share (DEPS). However IAS 33 defines dilution narrowly and considers only potential ordinary shares that are dilutive at the reporting date. The proposed disclosures would potentially be onerous to non-listed companies that currently do not need to apply IAS 33.
- To consider whether contracts with potential share redemptions or repurchases should also be included in the reconciliations
- To provide complete information about potential dilution, instruments in the scope of IFRS 2 *Share-based Payment* and minimum potential dilution should be disclosed

Maximum number of additional ordinary shares

- In line with the overall objective described on slide 6, the aim in developing these recommendations is not to repeat disclosures already required by IAS 33 or to amend IAS 33 to correct its perceived shortcomings. (See Appendix for summary of existing requirements in IAS 33 for the calculation of DEPS)
- The DEPS calculations aim to maximise the dilution of basic earnings per share and contain various requirements and assumptions for the calculations depending on the type of potential ordinary share .
- The maximum number is not the same as the number used in the DEPS calculations because it takes into account potential increases in the number of issued ordinary shares for the dilution regardless of the current conditions at the reporting date and therefore different assumptions are used in calculating the maximum number.

Potential disclosure refinements to the DP proposals

To address the challenges summarised on slide 13, the staff are exploring the following refinements to the proposed disclosures:

- For both **listed and unlisted** entities:
  - **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
  - Provide a **narrative explanation of any significant changes** in the maximum number compared to the prior period comparative numbers.
  - Provide a **narrative description of the instruments** accounted for under IFRS 2, eg employee share options. For this purpose, the entity could cross-refer to the relevant information provided in the IFRS 2 disclosures.
  - Provide information about the key terms and conditions that are relevant in understanding the potential dilution such as strike price, exercise date and if any, conditions for exercise. This disclosure can be combined with the terms and condition disclosures (see slide 22).

Calculation of maximum number

- In calculating the maximum number, the following will be required (different from the DEPS 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 as 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.

Questions for CMAC members

2. Would the potential disclosure refinements provide useful information for users of financial statements? If yes, for what purpose do you intend to use this information? In particular, would it be useful
   a) if this disclosure is provided as at the reporting date instead of a reconciliation of opening to closing balances?
   b) if this disclosure includes potential share redemptions or repurchases?
   c) if this disclosure includes a narrative description of IFRS 2 instruments that may be settled in shares?
3. To what extent would disclosure of the potential minimum number of additional ordinary shares be useful?
4. If relevant to your experience, would this disclosure be useful if provided only by listed entities?

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Information about Terms and conditions

Feedback on 2018 Discussion Paper

Key messages we heard from stakeholders including investors were:

- Concern about ‘disclosure overload’ especially for multinational entities which have many issued instruments or regulated entities that are already required to provide similar information
  - this disclosure should focus on instruments which are part of an entity's overall capital structure and financial instruments with characteristics of both equity and liabilities— 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.
  - cross referencing to publicly available information should be allowed.
- Investors are primarily interested in understanding future cash flows of the entity, for example:
  - conditions that trigger redemption or conversion,
  - conditions that allow an entity to defer the payment of interest,
  - significant restrictions on entity’s ability to transfer funds or repay debt and voting rights.

Potential disclosure refinements to the DP proposals

To address the challenges summarised on slide 21, the staff are exploring the following refinements:

- Disclose in a single note to the financial statements:
  - For **significant** financial liabilities and equity instruments disclose 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 any. If the voting right is only exercisable in specified circumstances, provide the description of those circumstances.
- The information could be provided in **a tabular format** ie a table of key terms with one line per type of instrument.

Simplified example of disclosure refinement

- 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.

Questions for CMAC members

5. Would the potential disclosure refinements provide useful information for users of financial statements? If yes, for what purpose do you intend to use this information? In particular, would it be useful
   a) if this disclosure only includes significant financial liabilities and equity instruments?
   b) if this disclosure only covers financial instruments where classification involves significant judgement because instruments have characteristics of both equity and debt?
   c) if this disclosure includes information about any voting rights?
6. Based on your experience, are there any particular types of terms and conditions of financial instruments that you would like companies to disclose in further detail?

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.

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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