STAFF PAPER

April 2021

IASB® meeting

Project	**Financial Instruments with Characteristics of Equity (FICE)**		
Paper topic	Terms and conditions disclosures		
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Introduction

1. At its February 2021 meeting, the Board discussed potential refinements to disclosure proposals explored in its 2018 Discussion Paper *Financial Instruments with Characteristics of Equity* (the 2018 DP). In this paper, the staff set out further refinements to the proposals on the terms and conditions disclosures.

2. One of the main questions raised at that meeting was how to best scope the disclosure to avoid disclosure overload while addressing the information needs of users of the financial statements, ie for which instruments the disclosure should be required and which terms and conditions should be disclosed.

3. This paper is structured in the following way:

    (a) objective of the terms and condition disclosures (paragraph 4);

    (b) staff's research on information available in listing documents (paragraphs 5–10);

    (c) scope—which instruments? (paragraphs 11–18);

    (d) scope—which terms and conditions? (paragraphs 19–52);

(e) illustrative examples (paragraphs 53–56);

(f) staff's recommendations (paragraph 57-58); and

(g) question for the Board (paragraph 59).

Objective of the terms and conditions disclosure

4. The Board's preliminary view set out in the 2018 DP was that information about terms and conditions affecting the amount and timing of cash flows of both financial liabilities and equity instruments would be useful to users of the financial statements if provided in the notes. Taking into account all the feedback from stakeholders on this topic and especially the needs of users of financial statements (see paragraphs 11-12 of this paper), the staff believe the objective of these disclosures should be to help users of financial statements better understand:

   (a) the nature, amount, timing and uncertainty of cash flows arising from financial instruments issued by an entity, in particular for those instruments that have characteristics of both debt and equity;

   (b) information not captured through classification as equity or financial liabilities but that is considered relevant to understand the nature of the financial instruments; and

   (c) the reason for classification as financial liabilities or equity instruments (eg why an instrument is classified as equity despite having debt-like features or why an instrument is classified as a financial liability despite having equity-like features).

Staff's research on information available in listing documents

5. Many stakeholders asked the Board to consider the information that is already required to be disclosed when developing new disclosure requirements. At the February 2021 meeting, in Agenda Paper 5A, the Board considered the disclosures financial institutions are required to provide under regulatory requirements such as BASEL III and Solvency II.

6. For the purpose of this meeting, the staff conducted further research to understand the types of information that are generally available to investors based on listing requirements that apply when securities are initially offered to the public or admitted to trading on a regulated market. It should be noted that these disclosures are not necessarily provided in the financial statements and may not be subject to the same financial reporting processes and controls as the information reported in the financial statements. Furthermore, there is no globally accepted set of listing requirements, such that listing requirements are likely to vary between different markets, jurisdictions and/or securities regulators.

7. We also acknowledge that not all instruments are listed and some offers of transferable securities to the public are exempt from the obligation to publish a prospectus. We also do not necessarily consider the information available in prospectuses as a substitute for information to be disclosed in the financial statements, especially if information in the prospectus is only applicable at the date the prospectus is published. However, we still think it is useful to understand the types of supplementary information which investors typically have access to when new instruments are issued.

8. Generally, a prospectus contains information relating to the issuer and information about the securities offered to the public or to be admitted to trading on a regulated market. Information in the prospectus about the issuer generally includes the following:

   (a) a brief description of the group and the issuer's position within the group and a list of the issuer's significant subsidiaries.

   (b) share ownership and any share options held by management and a description of any capital arrangements with employees.

   (c) whether the major shareholders have different voting rights, or a statement that no such voting rights exist.

   (d) a reconciliation of the number of shares outstanding at the beginning and end of the year for each class of share capital.

   (e) the amount of any convertible securities, exchangeable securities or securities with warrants, with an indication of the conditions and procedures for conversion, exchange or subscription.

(f) any capital of any member of the group which is under option and details of such options including persons to whom such options relate.

9. Information in the prospectus about the securities generally includes the following:

(a) description of the type and class of the securities being offered, including the international security identification number and currency of the securities issue.

(b) description of the rights attached to equity securities: (a) dividend rights including rate of dividend or method of calculation, cumulative or non-cumulative nature of payments; (b) voting rights; (c) pre-emption rights in offers for subscription of securities of the same class; (d) right to share in the issuer's profits; (e) rights to share in any surplus in the event of liquidation; (f) redemption provisions; (g) conversion provisions.

(c) description of the rights attached to non-equity securities: nominal interest rate; due dates for interest; maturity date; repayment procedures; indication of yield.

(d) indication of dilution for existing shareholders including a comparison of participation in share capital and voting rights for existing shareholders before and after the capital increase resulting from the public offer (assuming existing shareholders do not subscribe for the new shares).

10. In addition, the prospectus would generally include information related to the issuer's capital resources and funding structure and information on the level of seniority/subordination of securities in the event of insolvency. Further details about these information sources are documented in Agenda Paper 5B of this meeting as they are more relevant to the topic of disclosures about priority on liquidation.

Scope—which instruments?

Financial instruments with characteristics of both debt and equity

11. Over the years, the Board and other accounting standard-setters have developed many different approaches to distinguishing financial liabilities from equity instruments. However, the feedback on those approaches showed that there is no single approach that all stakeholders agree on. Many users of financial statements said that they often make their own classifications by making adjustments to the entity's classification. Some prefer a narrow equity approach because they consider all instruments other than ordinary shares as liabilities, while others think there should be a third, mezzanine category for instruments that have features of both debt and equity. In addition, some users of financial statements believe particular features such as subordination or loss absorption features or rights such as voting rights should be factored into the classification as financial liabilities or equity. Investors also told us that the availability of more information about financial instruments with classifications that are more complex to understand because they have characteristics of both debt and equity will allow market participants to better forecast future cash flows and better assess and understand classification of these instruments, and the differences between instruments.

12. As the Board acknowledged when developing the 2018 FICE DP, a binary distinction between financial liabilities and equity cannot meet all the information needs of users of the financial statements, especially given the broad spectrum of financial instruments that combine some features of a debt instrument with some features of an equity instrument. Disclosures would especially be important for such financial instruments to enable users of financial statements to understand the risks and returns of such instruments and how such instruments affect the solvency and liquidity of the entity.

13. Considering the feedback from users of financial statements and other stakeholders, the staff's preferred way of limiting the scope of the disclosure on terms and conditions is to focus on financial instruments with characteristics of both debt and equity. Such financial instruments will include:

(a) equity-classified instruments with characteristics of debt instruments (these characteristics hereafter referred to as 'debt-like features') (see paragraph28);

(b) financial liability-classified instruments with characteristics of equity instruments (these characteristics hereafter referred to as 'equity-like features') (see paragraph 29); and

(c) compound instruments that contain components classified as financial liabilities and equity instruments (paragraphs 32-33 and paragraph 48).

14. The staff considered other possible ways to scope the disclosure on the terms and conditions but decided not to pursue them. See paragraphs 15–18 of this paper.

Other complex financial instruments

15. There are other financial instruments that are complex for reasons other than having characteristics of both debt and equity. For example, if an entity issues a dated 5-year senior bond that pays a coupon linked to gold prices, the entity's exposure to, and uncertainty in cash flows because of, gold prices would be relevant to the decisions being made by investors. Such financial instruments are arguably complex because of their exposure to particular risks and not because they have characteristics of equity.

16. IFRS 9 *Financial Instruments* requires an entity to separate non-closely related embedded derivatives from financial liabilities and measure them at fair value through profit or loss unless the entity designates the entire instrument to be measured as at fair value through profit or loss. In addition, IFRS 7 *Financial Instruments: Disclosures* requires disclosure of the nature and extent of risks arising from financial instruments to which an entity is exposed. The disclosure requirements relating to market risk would be particularly relevant in this example. The staff therefore do not think additional disclosure requirements are needed for financial instruments that are complex because of their exposure to particular risks.

Financial instruments that require judgements in classification

17. Some national standard setters expressed support for aligning the proposed disclosures with the current requirements in paragraph 122 of IAS 1 *Presentation of Financial Statements* which states:

> An entity shall disclose, along with its significant accounting policies or other notes, the judgements, apart from those involving estimations (see paragraph 125), that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

18. This approach would limit the scope of the disclosures on terms and conditions to financial instruments for which classification requires significant judgement. However, the staff think this approach is more subjective and it may be difficult to clearly specify how significant the judgement needs to be to require the disclosure. In addition, there may be instruments that do not require any judgement in classification, for example, a financial instrument settled through a variable number of shares to the value of a fixed amount is classified as a financial liability because the entity is using its own shares as currency ie as a means to settle the contract. However, users of financial statements would benefit from further disclosures about the terms and conditions of such a financial liability.

Scope—which terms and conditions?

19. As discussed in the February 2021 meeting, there is currently no requirement in IFRS 7 to disclose the terms and conditions of financial instruments. Although some disclosures required by IFRS 7 could indirectly provide information about terms and conditions of financial instruments such as maturity analysis and market risk disclosure, the information is provided on an aggregated basis. The staff focused on identifying information about an entity's financial instruments

and transactions that primary users[1] might need to understand to make decisions about providing resources to the entity. As discussed in paragraphs 11–13 of this paper, the staff recommend the scope of the disclosures on terms and conditions to apply to financial instruments with characteristics of both debt and equity.

20. Considering the objective set out in paragraph 4 of this paper and our recommendation in paragraph 19, we believe information about the following types of terms and conditions would be useful to investors:

    (a) debt-like features in equity-classified instruments and equity-like features in financial liability-classified instruments which are not representative of the classification as equity or financial liabilities ie additional features will be flagged to investors. Considering the objective in paragraph 4(a), the disclosure requirements would focus particularly on the features that affect the nature, amount, timing or uncertainty of the cash flows of the financial instruments (see paragraphs 21–44); and

    (b) feature(s) that determine the classification of financial instruments (including compound instruments) so that investors can understand the reason for the classification (see paragraphs 45–52);

Debt-like features and equity-like features

21. In order to identify debt-like features, the staff considered the nature, amount and timing of the cash flows of a typical liability-classified financial instrument ie a plain vanilla bond. Similarly, in identifying equity-like features, we considered the characteristics of the cash flows of a typical equity-classified financial instrument ie ordinary shares.

22. The nature of the cash flows of a plain vanilla bond is interest and principal repayments. The cash flows are of fixed or determinable amounts ie they may vary with market variables such as interest rates. The cash flows occur at specified times. The holder is not entitled to participate in changes in economic resources of the entity beyond those specified cash flows. Based on the above, we think the

[1] The *Conceptual Framework for Financial Reporting* uses the term 'primary users' to refer to those existing and potential investors, lenders and other creditors who must rely on general purpose financial reports for much of the financial information they need.

key cash flow characteristics of 'typical' financial liabilities are specified timing and fixed or determinable amounts.

23. The nature of the cash flows of ordinary shares is a residual interest ie distribution of the entity's economic resources and returns after satisfying other claims against the entity's assets. The cash flows are thus of unspecified amounts that depend on changes in the entity's economic resources. The cash flows occur at unspecified times because they are affected by the entity's discretion to make payments and the entity's discretion to avoid making payments until liquidation. The amount of cash flows available to ordinary shareholders depends on the entity's financial performance and other events or transactions such as issuing debt or equity instruments. Based on the above, we think the key cash flow characteristics of 'typical' equity instruments are unspecified timing and unspecified amounts.

24. The cash flow characteristics described in paragraph 22–23 of this paper are typically expected to be found in financial liabilities and equity instruments, respectively. However, for financial instruments with characteristics of both debt and equity, their classification alone would not represent all the cash flow characteristics of the instruments. Equity-classified instruments may include some debt-like cash flows and vice versa.

25. The staff think it would be useful for users of the financial statements to understand these contractual features that result in cash flows that are not representative of the classification of the instruments. Entities should thus be required to highlight those features that do not affect the classification but are useful for users to understand their existence.

26. Therefore, based on the analysis in paragraph 22 of this paper, if a financial instrument is classified as a financial liability but has cash flows with characteristics that are not consistent with the key cash flow characteristics of financial liabilities (ie specified timing and fixed or determinable amounts), information about the contractual (equity-like) feature(s) that leads to such other cash flows would be useful.

27. Similarly, based on the analysis in paragraph 23 of this paper, we think if a financial instrument is classified as an equity instrument but has cash flows with characteristics that are not consistent with the key cash flow characteristics of

equity instruments (ie unspecified timing and unspecified amounts), information about the contractual (debt-like) feature(s) that leads to such other cash flows would be useful.

Debt-like features in equity-classified financial instruments

28. Debt-like features in equity instruments are features that result in cash flows that have similar characteristics to those of a debt instrument as described in paragraph 22 of this paper. Since these are equity-classified instruments, debt-like features do not create contractual obligations to transfer cash. Debt-like features may specify the amount or timing of the cash flows, which the entity has the contractual right to avoid. Debt-like features may influence the entity to transfer debt-like cash flows even if it has no obligation to do so. The following table gives examples of debt-like features in equity-classified instruments:

Debt-like features	**Examples**
A feature that specifies the amount and timing of cash flows (although the issuer has the contractual right to avoid or defer payment until its liquidation) Issuer may be exposed to changes in market variables (eg interest rate, foreign currency exchange rate) if it exercises that discretion to make payment.	Perpetual instruments and irredeemable preferred shares with **fixed cumulative coupons and specified coupon dates** (which may have additional interest accrued on the deferred coupons) and **fixed principal** which the issuer is only obliged to pay on liquidation
	Instruments where the issuer has the choice to settle in **a fixed amount cash** or a fixed number of shares **at a specified date** eg reverse convertibles are equity-classified but the issuer can choose to pay in cash at settlement date. See paragraph 39-40 of this paper.

	Perpetual instruments that can be called by the issuer **after x number of years** and is payable in **a fixed amount of a specific currency.**
A feature that creates an incentive for the issuer to transfer a specified amount of cash at a specified time (although the issuer has the contractual right to avoid or defer payment until its liquidation.)	Perpetual instrument with **stepped interest payments** if the issuer does not choose to redeem **at a specified date.**
	Perpetual instrument with contractual features that may create incentives to pay **a specified amount of coupons**, eg dividend pusher or stopper, or give the holder the right to vote in shareholders' meetings if the issuer decides to skip or defer coupons.

Equity-like features in liability-classified financial instruments

29. Equity-like features in financial liabilities are those features that result in cash flows that have similar characteristics to those of ordinary shares as described in paragraph 23 of this paper. Since these are liability-classified instruments, equity-like features do not generally negate the issuer's contractual obligations to transfer cash where such obligations exist. Rather, equity-like features may affect the amount or timing of the cash flows, which the entity is obliged to transfer. However, in some cases, equity-like features may result in the entity transferring its own equity instruments to settle an obligation or the issuer not paying the full amount of the obligation. The following table gives examples of equity-like features in liability-classified instruments:

Equity-like features	**Examples**

A contractual obligation to pay the holder an amount based on the entity's performance or changes in the entity's economic resources.	Instrument that obliges the issuer to pay the holder amounts based on a specified % of **profit** or specified % of the **share price**.
	Shares redeemable **at fair value** ie the amount payable is based on the entity's **share price** at settlement date.
A feature that requires instrument holders to absorb losses arising from changes in the economic resources of the entity on the occurrence of specified events or requires payment after other instruments are paid ie subordination features.	Instrument where the amount repayable is **written down** on the occurrence of a specified trigger event eg capital ratio decreases below x.
	Subordinated debt ie holder has higher risk of not recovering the full contractual cash flows should the issuer be liquidated.
Issuer's contractual right to avoid transferring cash for a specified period of time.	Redeemable instrument where the issuer has **the right to defer or cancel** coupon payments (or the coupons are non-cumulative and discretionary) for a specified period of time, eg right to cancel coupons for x number of periods.
Issuer's contractual right or obligation to settle the instrument by transferring own equity instruments instead of cash.	**Share-settled** debt where the issuer uses its own equity instruments as currency to settle the obligation.
	Convertible bonds that are classified as financial liabilities in their entirety because the conversion option does not meet the fixed-for-fixed condition

	(see footnote 2) in IAS 32 eg bonds convertible into a variable number of the entity's own shares.
	Instruments classified as liabilities due to indirect obligations eg the issuer has the **choice to settle in** cash or **shares** whose value substantially exceeds the cash value.

30. The staff note that subject to the Board's decision, the potential dilution disclosures would require disclosures of information about instruments that are or may be settled in ordinary shares of the entity (see Agenda Paper 5C for this meeting). The information disclosed would include key terms and conditions relevant to understanding maximum dilution and the possibility for unknown dilution. Entities would not need to repeat the information that is already provided in the potential dilution disclosures. We further note that some non-derivative financial liabilities that could be settled in own shares could have other equity-like features which are not covered by the potential dilution disclosures and the disclosures on terms and conditions would capture these additional features.

31. The staff also note that subject to the Board's decision, the information about priority on liquidation would also be required for instruments with characteristics of both equity and debt (see Agenda Paper 5B for this meeting). The information disclosed would include terms and conditions that indicate priority on liquidation or that could lead to changes in priority (eg conversion features and contingent features, and whether multiple subordination levels exist within a particular type of financial instrument.

Debt-like and equity-like features of compound instruments

32. Compound instruments (pre-separation into components) have characteristics of both debt and equity. Paragraph 17 of IFRS 7 only requires disclosures of features

[2] Applying paragraphs 11 and 16 of IAS 32, a derivative financial instrument is an equity instrument only if it will be settled by the issuer exchanging a fixed amount of cash (or another financial asset) for a fixed number of its own equity instruments. This is commonly referred to as the 'fixed-for-fixed' condition.

of compound financial instruments with multiple embedded derivatives whose values are interdependent (such as a callable convertible debt instrument). The staff note that paragraph 31 of IAS 32 requires the value of any derivative features (such as a call option) embedded in the compound financial instrument other than the equity component (such as an equity conversion option) to be included in the liability component.

33. However, for other compound financial instruments, there are no specific disclosure requirements and therefore after separation, it is not always made clear that the components were part of a compound instrument. We therefore think information about the priority on liquidation of compound instruments (see Agenda Paper 5B of this meeting) and information about debt-like and equity-like features in compound instruments as a whole would be useful to users of the financial statements. The disclosure of debt-like and equity-like features would also help users to understand the classification of the components of compound instruments because these debt-like and equity-like features affect the classification of the components (see paragraph 48 of this paper).

Derivatives on own equity

34. The staff considered whether the disclosures of debt-like features and equity-like features would be relevant to derivative instruments. The purpose of our analysis is to assess the benefits of including derivatives within the scope of the disclosure on terms and conditions given the concerns raised by stakeholders around disclosure overload. If the idea explained in paragraph 18(a) were to apply to derivatives, disclosures would be required for debt-like features in equity-classified derivatives and equity-like features in derivative assets or derivative liabilities. However, in the staff's view, standalone derivatives on own equity should be scoped out. Our reasons are set out below.

35. Firstly, we do not expect many equity-classified derivatives to have debt-like features. The classification of derivatives as equity or financial liabilities depends on the fixed-for-fixed condition discussed in paragraph 29 of this paper. Considering the fixed-for-fixed condition and the clarifying principle discussed by the Board in this regard in April 2020, one notable example of equity-classified derivatives that have debt-like features would be foreign currency rights issue.

The staff have not identified any significant information gaps about such transactions. We think it is unlikely that other equity-classified derivatives would have debt-like features.

36. On the other hand, we do expect many liability-classified derivatives on own equity to have at least one equity-like feature. This is the case because such derivatives will or may be settled in the entity's own equity instruments or for a value based on the entity's share price. Derivative on own equity would be classified as financial assets or financial liabilities if they fail the fixed-for-fixed condition. In addition, where settlement options exist, most derivatives would not be classified as equity instruments. Paragraph 26 of IAS 32 states:

> When a derivative financial instrument gives one party a choice over how it is settled (eg the issuer or the holder can choose settlement net in cash or by exchanging shares for cash), it is a financial asset or a financial liability unless all of the settlement alternatives would result in it being an equity instrument.

37. Therefore, some may argue that derivatives on own equity that are classified as financial assets or financial liabilities should be scoped in to highlight their equity-like features. However, the staff would like to highlight, as noted in paragraph 30 of this paper, the potential dilution disclosures would require information about instruments that are or may be settled in own equity, including derivative liabilities that are settled in own shares. The staff think the most important equity-like feature in these derivative assets or liabilities is settlement in own equity, which would be covered by these potential dilution disclosures.

38. In addition, the staff considered embedded derivatives on own equity. The most common form of derivatives on own equity is conversion options in convertible bonds. Where the conversion option is an embedded derivative liability, it would be scoped in the terms and conditions disclosures, as discussed in paragraph 30 of this paper. This is because the equity-like feature in a non-derivative financial liability often arises from the embedded derivative. Therefore, where such an embedded derivative on own equity itself has both debt and equity like features, it would be scoped into the disclosures on terms and conditions. Where the

conversion option is a derivative that meets the fixed-for-fixed condition, the disclosure proposed for compound instruments would apply (see paragraph 48).

Financial instruments with alternative settlement outcomes that are controlled by the entity

39. One of the questions considered in the 2018 DP was whether the Board should address the accounting for financial instruments with alternative settlement outcomes that are within the control of the entity. Some financial instruments have alternative settlement outcomes and give the entity an unconditional right to choose the settlement outcome. An example of such instruments is reverse convertible bonds issued by the entity that grants the entity the unconditional right to settle the bond either by delivering a fixed number of its own shares at any time, or by paying a fixed amount of cash at the bond's maturity. Applying the current IAS 32 requirements, many reverse convertible bonds are classified as equity as the issuer can avoid settling the obligation in cash by delivering a fixed number of its own shares.

40. The 2018 DP considered potential ways to provide information about the alternative settlement outcome of paying in cash and asked respondents if the Board should address this issue and, if so, what approach would be most effective in providing the information. Most respondents to these questions agreed that the Board should address this issue through additional disclosure requirements that provide information about alternative settlement outcomes (Agenda Paper 5D of June 2019 meeting). The staff think such information should be provided as part of the terms and conditions disclosures, particularly the debt-like features in equity-classified financial instruments.

Debt-like and equity-like features that do not affect cash flows

41. There are some features that may be regarded as debt-like or equity-like but do not affect the cash flows of financial instruments directly. For example, tax deductibility of coupon payments may be regarded as a debt-like feature and eligibility as regulatory capital instruments (for financial institutions that are subject to relevant regulations) may be regarded as an equity-like feature. The staff's preference would be to limit the scope of the terms and conditions disclosures to those features that affect the cash flows of financial instruments, in

line with the objective discussed in paragraph 4(a) of this paper. In addition, we note that information related to tax and regulatory requirements is beyond the scope of financial instruments disclosures and may already be subject to other disclosure requirements.

42. Some investors mentioned the existence of voting rights as the terms and conditions that would be particularly relevant to their decision-making. Some of them held the view that voting rights are one of the key features of instruments that they consider to be equity instruments.

43. The staff think information about voting rights for some equity instruments are already required in the financial statements as paragraph 79(a)(v) of IAS 1 requires disclosure of the rights, preferences and restrictions attaching to each class of share capital including restrictions on the distribution of dividends and the repayment of capital. In addition, although we acknowledge the information is provided in another context, paragraph 12 of IFRS 12 *Disclosure of Interest in Other Entities* requires disclosure of the proportion of voting rights held by non-controlling interest, if different from the proportion of ownership interests held.

44. The staff acknowledge that voting rights are not a feature that directly affect the cash flows of financial instruments. We also note that many financial instruments contain a protective right to vote in the event the issuer defaults on the instruments. Considering the objective described in paragraph 4(a) of this paper, we think the scope of any voting rights disclosure should be limited to cases in which the voting rights are linked to the cash flows of the financial instruments. In particular, as mentioned as one of the examples of debt-like features in paragraph 28 of this paper, voting rights may be used as an incentive for the issuer to transfer cash even if the issuer has no contractual obligation to do so. We think such voting rights reinforce the debt-like characteristics of the cash flows in equity-classified instruments (for example irredeemable preference shares) and would be relevant for investors to understand the nature, amount, timing and uncertainty of the cash flows of the financial instruments.

Terms and conditions that determine the classification

45. In Agenda Paper 5E for the February 2021 meeting, the staff provided their findings on a review of the financial statements of selected companies to understand the current classification of perpetual instruments and how they are presented in the financial statements. The staff noted that many companies that have issued perpetual financial instruments containing an obligation that arises only on liquidation, explained why the instruments are classified as equity instruments. However, many of the explanations provided was generic: 'these financial instruments are classified as equity under IAS 32 because they do not contain any contractual obligation to deliver cash'. As mentioned earlier in this paper, there is also no IFRS 7 requirement to disclose terms and conditions of financial instruments. Understandably, users of financial statements have told us they would benefit from more informative and meaningful disclosures about the classification decision of financial instruments with characteristics of both debt and equity, in combination with the disclosure of debt-like and equity-like features as set out in paragraphs 21–44 of this paper.

46. The staff believe that useful information could be provided if entities are required to explain why particular instruments were classified as equity despite their debt-like features. For example, after describing debt-like features of a perpetual instrument, an entity could explain that the perpetual instruments are classified as equity because the entity has an unconditional right to defer those debt-like cash flows until liquidation of the entity.

47. Similarly, entities would be required to explain why particular instruments were classified as financial liabilities despite their equity-like features. For example, some convertible bonds are classified as financial liabilities in their entirety because the conversion option does not meet the fixed-for-fixed condition in IAS 32. The staff think that they would be considered as financial liabilities with equity-like feature because they would have at least one equity-like feature, ie settlement in the entity's own equity instruments. After describing equity-like features in the liability-classified convertible bonds[3], an entity should explain the

[3] If the share-settlement feature is the only equity-like feature, the information about such a feature would be provided by the potential dilution disclosures (see Agenda Paper 5C for this meeting).

features that led to its classification as financial liabilities (including the feature(s) that is inconsistent with the fixed-for-fixed condition).

48. In the staff's view, information should also be provided about both debt-like and equity-like features in all compound instruments so that users of financial statements can understand the classification of the components of compound instruments. Examples of compound instruments with debt-like and equity-like features include:

    (a) convertible bonds containing options for the holders to convert into shares and fixed rate coupons;

    (b) redeemable preference shares with discretionary dividends; and

    (c) bonds mandatorily convertible into a fixed number of ordinary shares with fixed rate coupons.

49. In addition, the staff believe better explanation of material accounting policies would help users of financial statements understand the accounting classification and accounting treatment of financial instruments with characteristics of both debt and equity. Paragraph 5 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* defines accounting policies as the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.

50. In February 2021, the Board issued an amendment to IAS 1 and IFRS Practice Statement 2 *Making Materiality Judgements* on the disclosure of accounting policies. The Board acknowledged that because the complexity of accounting required for particular transactions, other events or conditions is ultimately a subjective question, an entity will need to judge whether the relevant accounting is complex.

51. Paragraph 117B of IAS 1 states:

> Accounting policy information is expected to be material if users of an entity's financial statements would need it to understand other material information in the financial statements.[…]

52. Paragraph 88F of Practice Statement 2 states:

> Although entity-specific accounting policy information is generally more useful, material accounting policy information could sometimes include information that is standardised, or that duplicates or summarises the requirements of the IFRS Standards. Such information may be material if, for example:
>
> (a) users of the entity's financial statements need that information to understand other material information provided in the financial statements. Such a scenario might arise when an entity applying IFRS 9 *Financial Instruments* has no choice regarding the classification of its financial instruments. In such scenarios, users of that entity's financial statements may only be able to understand how the entity has accounted for its material financial instruments if users also understand how the entity has applied the requirements of IFRS 9 to its financial instruments.
>
> (b) an entity reports in a jurisdiction in which entities also report applying local accounting standards.
>
> (c) the accounting required by the IFRS Standards is complex, and users of financial statements need to understand the required accounting. Such a scenario might arise when an entity accounts for a material class of transactions, other events or conditions by applying more than one IFRS Standard.

Illustrative examples

53. The staff set out below a number of illustrative examples. The purpose of these illustrative examples is to show how an entity could disclose information about the relevant features discussed in paragraphs 28–29 and paragraphs 45–48 of this paper. Accordingly, we have not tried to include all disclosures that are already required by currently effective IFRS Standards.

54. Company X has perpetual subordinated notes that are classified as equity instruments.

Note 16 Perpetual subordinated notes

At 31 December 2020, the total perpetual subordinated notes outstanding amounted to CU3,985 million (less net-of-tax transaction costs) and are included in the Company's equity. The table below includes the key terms of these financial instruments.

	Notional amount	Initial call date	Coupon reset after initial call date	2020 CU million	2019 CU million
5.5% Fixed Rate Subordinated Notes	USD 1,000m	Jan 2025	10.5%	690	714
4.5% Fixed Rate Subordinated Notes	EUR 750m	Mar 2028	market rate	647	658
4% Fixed Rate Subordinated Notes	EUR 2,000m	Oct 2032	market rate	1,724	-
3% Fixed Rate Subordinated Notes	GBP 1,000m	Jan 2027	market rate	925	910
				3,985	2,282

Coupon

These notes bear a fixed rate of coupon until their initial call dates. After the initial call dates, if they are not redeemed, the coupon on the notes reset. The coupon on the USD subordinated notes reset to 10.5%. The coupon on the other notes are fixed periodically in advance for five-year periods, based on prevailing market interest rates plus credit spreads of Company X, fixed at issuance.

Company X has discretion to defer coupons on these notes. The deferred coupons accumulate and become payable at the call date if the notes are called, or when Company X is liquidated, if the notes are not called.

Company X is prevented from paying dividends or other distributions in respect of its ordinary shares, or from repurchasing its ordinary shares, until the cumulative coupons on the perpetual subordinated notes have been paid in full.

Redemption option

These notes are redeemable at the option of Company X at the initial call date or any fifth anniversary after this date. The amount redeemable will be the notional amount plus accumulated coupons.

Classification

These notes are classified as equity instruments because Company X has the unconditional contractual right to defer coupons and principal repayments until liquidation of Company X.

Priority on liquidation

[Information about priority of the notes on liquidation of Company X (see Agenda Paper 5B for this meeting.)]

55. Company Y has convertible bonds that are accounted for as financial liabilities in their entirety.

Note 12 Long-term borrowings

	2020 CU million	2019 CU million
Bonds	27,500	29,920
Bank loans	1,500	2,300
Lease liaiblities	9,700	10,820
Other long-term borrowings	3,215	4,250
	41,915	47,290

On 1 April 2020, Company Y issued CU3.2 billion of convertible bonds. These are included in *Bonds* in the table above.

The convertible bonds bear coupon of 1.5% and mature in February 2024.

At maturity, holders of the bonds are entitled to convert the bonds into ordinary shares of Company Y at a fixed contractual conversion price of CU2.70. If, prior to the maturity date of the convertible bonds, Company Y issues ordinary shares in the market at a price lower than the conversion price of the convertible bond, the conversion price will be adjusted to be the same as the price of the shares that are issued. If there are multiple issuances at a price lower than the conversion price, the conversion price will be adjusted to the same as the latest issuance price. Because of this potential adjustment to the conversion price, the conversion option could be settled by delivering a variable number of shares. Therefore, the convertible bonds are classified as financial liabilities in their entirety.

[Information about priority of the convertible bonds on liquidation of Company Y (See Agenda Paper 5B for this meeting)].

For information about potential dilution, see note 19. (See Agenda Paper 5C for this meeting)

56. Company Z has mandatory convertible bonds that are accounted for as compound instruments.

Note 18 Mandatory convertible bonds

On 1 April 2020, Company Z issued CU1.2 billion of mandatory convertible bonds.

Mandatory convertible bonds bear coupon of 1.2% and mature in December 2023. At maturity, the bonds convert into ordinary shares of Company Z at a fixed contractual conversion price of CU5.50.

These bonds are accounted for as compound instruments applying IAS 32. The fair value of future coupons (CU 0.1 billion) is recognised as financial liabilities in Borrowings because Company Z has no contractual right to avoid paying those coupons. The residual amount (CU 1.1 billion), after deducting the fair value of the liability from the fair value of the instrument as a whole is recognised in shareholders' equity. The equity component represents the fixed number of ordinary shares to be delivered at maturity.

For information about potential dilution, see note 19. (See Agenda Paper 5C for this meeting)

[Information about priority of the mandatory convertible bonds on liquidation of Company Y (See Agenda Paper 5B for this meeting).]

Staff's recommendations

57. Based on the analysis set out in this paper, the staff recommend that for financial instruments with characteristics of both debt and equity, an entity would be required to disclose information about key terms and conditions that enables users of the financial statements to better understand:

    (a) the nature, amount, timing and uncertainties of cash flows arising from these financial instruments issued;

    (b) information about the financial instrument's characteristics that do not affect its classification as equity or financial liabilities but is considered important to understand the nature of the financial instruments; and

    (c) the reason for classification as financial liabilities or equity instruments, or compound instruments (eg why an instrument is classified as equity despite having debt-like features or why an instrument is classified as a financial liability despite having equity-like features).

58. To meet the above objectives, the staff recommend the following disclosures to be incorporated into IFRS 7 for financial instruments that have characteristics of both debt and equity (except for standalone derivatives):

(a) debt-like features in financial instruments that are classified as equity;

(b) equity-like features in financial instruments that are classified as financial liabilities; and

(c) debt-like and equity-like features that determine the classification of the financial instruments with characteristics of both debt and equity or the classification of components of compound financial instruments.

Question for the Board

59. The staff would like to ask the Board the following question.

Question for the Board
Does the Board agree with the staff's recommendations set out in paragraphs 57–58 of this paper?