STAFF PAPER

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IFRS® Interpretations Committee meeting

Project	**Accounting for warrants that are classified as financial liabilities on initial recognition (IAS 32)**
Paper topic	Initial Consideration

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Introduction

1. The IFRS Interpretations Committee (Committee) received a submission about whether, applying IAS 32 *Financial Instruments: Presentation*, an issuer reclassifies a derivative financial liability to equity after initial recognition in particular circumstances.

2. The objective of this paper is to:

   (a) provide the Committee with a summary of the matter;

   (b) present our analysis; and

   (c) ask the Committee whether it agrees with our recommendation not to add a standard-setting project to the work plan.

Structure of the paper

3. This paper includes the following:

   (a) background information (paragraphs 5–12);

(b) staff analysis and assessment against the Committee’s agenda criteria (paragraphs 13–26); and

(c) staff recommendation (paragraph 27).

4. There are two appendices to this paper:

(a) Appendix A—proposed wording of the tentative agenda decision; and

(b) Appendix B—submission.

Background information

The question

5. The submitter described a fact pattern in which an entity issues a warrant that gives the holder the right to buy the entity’s own equity instruments for an exercise price that will be fixed at a future date[1]. The submitter notes that, applying IAS 32, the issuer classifies the warrant at initial recognition as a financial liability because the amount of cash that the issuer will receive in exchange for its equity instruments is not fixed—ie the ‘fixed-for-fixed’ condition is not met at initial recognition.[2] The submitter asks whether the issuer reclassifies the warrant as equity when the exercise price is subsequently fixed.

6. The submitter says IAS 32 does not provide explicit requirements related to whether an issuer reclassifies a warrant from a financial liability to an equity instrument if, according to the contractual terms of the contract, the exercise price is fixed at a future date—ie if the fixed-for-fixed condition is not met at initial recognition but is met at a later date. The submitter describes three views that it has observed in practice:

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[1] The staff have assumed in this agenda paper that the number of the entity’s own equity instruments is fixed because the submitter refers only to variability in the exercise price.

[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.

(a) View 1—the issuer is prohibited from reclassifying the warrant;

(b) View 2—the issuer has an accounting policy choice with regards to reclassifying the warrant; and

(c) View 3—the issuer is required to reclassify the warrant.

7. Applying View 1, the issuer is prohibited from reclassifying the warrant and, therefore, the warrant continues to be classified as a financial liability when the exercise price is subsequently fixed. Proponents of View 1 say the following IFRS requirements support their view:

(a) paragraph 15 of IAS 32 requires an issuer of a financial instrument to classify a financial instrument *on initial recognition*;

(b) paragraph 3.3.1 of IFRS 9 *Financial Instruments* requires an issuer to derecognise a financial liability *when, and only when*, it is extinguished—ie when the obligation specified in the contract is discharged or cancelled or expires; and

(c) paragraph 3.3.2 of IFRS 9 requires a *substantial modification of the terms* of an existing financial liability to be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

8. Proponents of View 1 say IAS 32 does not envisage reclassifying a financial instrument after initial recognition. In addition, they say, in the fact pattern described in the submission, the derecognition requirements in IFRS 9 are not met when the exercise price is fixed because the liability is not extinguished. Furthermore, there has not been a substantial modification as described in IFRS 9 because the original contractual terms of the warrant specify the exercise price will be fixed at a future date. Accordingly, applying View 1, the issuer is prohibited from reclassifying or derecognising the warrant in the fact pattern described in the submission. As a result, the warrant would continue to be classified as a financial liability when the exercise price is subsequently fixed.

9. Applying View 2, the issuer has an accounting policy choice with regards to reclassifying the warrant. Proponents of View 2 acknowledge the arguments described in View 1 but

say, on the other hand, IAS 32 does not prevent an entity from reassessing the nature of a financial instrument and its classification to reflect changes in facts and circumstances. They say the substance of the warrant has changed into that of an equity instrument when the exercise price is subsequently fixed because the warrant would satisfy the fixed-for-fixed condition in IAS 32 if the condition was assessed at that date. Proponents of View 2 say it would be misleading to continue to classify the warrant as a financial liability after the exercise price is fixed. Proponents of View 2 think the issuer has an accounting policy choice with regards to reclassifying the warrant in the fact pattern described in the submission.

10. Applying View 3, the issuer would be required to reclassify the warrant when the exercise price is subsequently fixed. Proponents of View 3 share the arguments described in View 2 but say reclassification is required because the effective terms of the instrument have changed solely due to the passage of time. Proponents of View 3 say the requirements in paragraph 3.3.1 of IFRS 9 for derecognising a financial liability are met when the features of the warrant change into that of an equity instrument (even though this outcome was set out in the original contractual terms of the financial instrument).

Outreach

11. The purpose of any outreach we perform is to understand:

    (a) the prevalence of the transaction or fact pattern submitted; and

    (b) the accounting applied to that transaction or fact pattern.

12. We decided not to perform outreach on this matter for the following reasons:

    (a) Stakeholders have told us the warrant described in the submission (or instruments with similar contractual terms) could be prevalent in some jurisdictions. For example, many respondents to the Board's 2018 Discussion Paper *Financial Instruments with Characteristics of Equity* (2018 FICE DP) raised the matter of reclassifying financial instruments as a practice issue applying IAS 32. The staff flagged this matter to the Board in October 2019 as

a topic that the Board could consider in its Financial Instruments with Characteristics of Equity project (FICE project).[3] In addition, the submitter says this matter might be present in multiple jurisdictions.

(b) We are aware of different views in practice about how to account for the warrant described in the submission (and for instruments with similar contractual terms)—that is, whether the issuer is prohibited from reclassifying or is required or has a choice to reclassify the warrant. The feedback from some stakeholders, including feedback received on the 2018 FICE DP, highlighted the view that the requirements in IAS 32 are unclear about whether an entity reassesses the classification of a financial instrument after initial recognition (especially when the instrument's contractual terms are unchanged), and if so, in what circumstances. The staff note the published guidance in the accounting manuals of large accounting firms describe the different views in practice on this topic. In addition, the submitter says, they and national enforcers, as part of their monitoring and supervisory activities, have identified divergent application of the requirements of IAS 32 in accounting for these types of instruments.

Staff analysis and assessment against the Committee's agenda criteria

Reclassification when the contractual terms are unchanged

13. The submitter describes a specific fact pattern—ie a warrant or similar financial instrument that provides the holder with the right to buy a fixed number of equity instruments of the issuer for an exercise price that will be fixed at a future date. The exercise price becoming fixed at a future date is a contractual term of the financial

[3] In December 2020, the Board moved the FICE project from its research programme to its standard setting programme.

instrument from inception that will occur after the passage of time, ie there is not an amendment to the instrument's contractual terms.

14. Based on the staff's research, discussions with some stakeholders and feedback on the 2018 FICE DP, it is evident that questions about whether IAS 32 permits reclassification after initial recognition arise in other circumstances. Examples of other circumstances include the following:

    (a) a warrant that provides the holder with the right to buy a fixed number of the issuer's own equity instruments in exchange for a fixed amount of cash denominated in the issuer's functional currency. At initial recognition, the issuer classifies the warrant as an equity instrument because it meets the fixed-for-fixed condition. After initial recognition of the warrant, the issuer's functional currency changes and, as a result, the amount of cash to be exchanged is no longer 'fixed' in the issuer's functional currency. The inverse of this example could also arise—ie at initial recognition, the warrant is classified as a financial liability because the amount of cash to be exchanged is denominated in a currency other than the issuer's functional currency but, subsequently, the issuer's functional currency changes such that the amount of cash to be exchanged is considered 'fixed'.

    (b) a derivative issued by a parent that will be settled by the parent delivering a fixed number of its subsidiary's equity instruments in exchange for a fixed amount of cash. At initial recognition, the derivative is classified as an equity instrument in the consolidated financial statements because it meets the fixed-for-fixed condition. After initial recognition of the derivative, the parent loses control of that subsidiary and, as a result, the derivative will no longer be settled by exchanging a fixed number of the group's 'own equity'. The inverse of this example could also arise—ie after initial recognition of a derivative liability, the issuer *gains* control of subsidiary such that the derivative will be settled by exchanging a fixed number of the group's 'own equity' for a fixed amount of cash.

(c) a financial instrument that requires the issuer to deliver cash or another financial asset (or otherwise to settle it in a way that would be a financial liability) only if a contingent event occurs. At initial recognition of the financial instrument, the contingent event is not within the control of the issuer and, as a result, the instrument is classified as a financial liability. Subsequently, that contingent event becomes within the control of the issuer. The inverse of this example could also arise—ie at initial recognition, the contingent event is within the control of the issuer but ceases to be so at a later date.

(d) contingent consideration in business combinations that the entity will settle by delivering its own equity instruments. The number of shares to be delivered will be fixed at a future date.

15. Based on this feedback from stakeholders, the staff think the fact pattern described in the submission is part of a broader practice issue. We think the specific fact pattern described in the submission should not be analysed in isolation but should form part of a more comprehensive analysis of whether an entity reassesses the classification of a financial instrument after initial recognition when the instrument's contractual terms are unchanged. Analysing this single example in isolation could have unintended consequences for fact patterns that raise similar questions about the application of IFRS Standards.

Applicable requirements in IFRS Standards

16. Applying paragraph 15 of IAS 32, an issuer of a financial instrument classifies the instrument, or its component parts, *on initial recognition* in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument.

17. There are no general requirements in IAS 32 for reclassifying financial liabilities and equity instruments after initial recognition. Paragraphs 16E-16F of IAS 32 set out

requirements for reclassifying *specific* instruments—ie puttable instruments and instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation (hereafter collectively referred to as 'puttable instruments'). Applying those requirements, reclassification is required when an instrument meets (or ceases to meet) the relevant conditions and/or has (or ceases to have) all the relevant features set out in paragraphs 16A-16D of IAS 32. However, these requirements do not apply to the fact pattern described in the submission—or indeed to any instrument other than puttable instruments—and cannot be applied by analogy. Paragraph 96B of IAS 32 explains that the requirements for puttable instruments was a limited scope exception and cannot be applied by analogy.

18. IFRS 9 sets out the requirements for derecognising financial liabilities. Applying paragraph 3.1.1 of IFRS 9, a financial liability (or a part of a financial liability) is removed from the statement of financial position when, and only when, it is extinguished—ie when the obligation specified in the contract is discharged or cancelled or expires.

19. As previously described in this paper, some stakeholders have told us—including in the feedback to the 2018 FICE DP—that, because there are no general requirements in IAS 32 for reclassifying financial liabilities and equity instruments after initial recognition, it is unclear whether an entity reassesses the classification of a financial instrument after initial recognition. In addition, as mentioned in paragraph 12(b) of this paper, the published guidance of large accounting firms describes the different views in practice on the topic of reclassifications without an amendment of the contractual terms. Some large accounting firms require reclassification, others allow an accounting policy choice to reclassify and the examples of circumstances in which reclassification is required or permitted also differ across the large accounting firms.

20. Some stakeholders have also told us that the interaction between IAS 32 and the derecognition requirements in IFRS 9 on this matter is unclear. Indeed, the submission refers to both 'reclassifying' the financial liability to an equity instrument *and* 'derecognising' the financial liability and 'recognising' an equity instrument. It appears

that at least some stakeholders, in some circumstances, might use this wording interchangeably.

21. Based on this feedback from stakeholders, as previously described in this paper, the staff flagged this matter to the Board as a topic to consider in its FICE project.

The Board's FICE project

22. Reclassification between financial liabilities and equity instruments was identified as one of the practice issues the Board will consider addressing in its FICE project. The FICE project is on the Board's standard setting programme.

23. In the FICE project, the Board is focusing on clarifying some underlying principles in IAS 32 and adding application requirements to facilitate consistent application of the principles. Where there is no implicit or explicit principle underpinning a particular IAS 32 requirement, the Board could decide to develop a principle. In analysing this particular practice issue, the staff expect the Board to consider the relevance and effect of the derecognition requirements in IFRS 9 (and the interaction between those requirements and IAS 32). This approach is broader than the work the Committee could undertake and thus reduces the risks outlined in paragraphs 13-15 of this paper.

24. In other words, this matter has been identified as an area where the Board may need to do standard setting as part of a project currently on its standard setting programme.

Should the Committee add a standard-setting project to the work plan?

Can the matter be resolved efficiently within the confines of the existing Standards and the Conceptual Framework? [4]

Is the matter sufficiently narrow in scope that the Board or the Committee can address it in an efficient manner, but not so narrow that it is not cost-effective for the Board or the Committee and stakeholders to undertake the due process required to change a Standard? [5]

25. Based on our analysis in paragraphs 13-24 of this paper, the staff conclude that the matter submitted is, in isolation, too narrow for the Board or the Committee to address efficiently and it would not be cost-effective to undertake the due process required to change a Standard. As described in paragraph 14 of this paper, similar questions arise in other circumstances and the staff think the fact pattern described in the submission is part of a broader practice issue and therefore should not be analysed in isolation.

26. Additionally, the staff think that this matter cannot be resolved efficiently within the confines of the existing Standards and the *Conceptual Framework*. The matter of reclassifying financial instruments by the issuer was identified as a practice issue and has been flagged to the Board. It has been identified as an area where standard setting may be necessary and is currently within the scope of the Board's FICE project.

Staff recommendation

27. Based on our assessment of the Committee's agenda criteria in paragraph 5.16 of the *Due Process Handbook* (discussed in paragraph 25-26 of this paper), we recommend that the Committee does not add a standard-setting project to the work plan. Instead, we recommend publishing a tentative agenda decision that explains that the matter is too

[4] Paragraph 5.16(c) of the *Due Process Handbook*.

[5] Paragraph 5.16(d) of the *Due Process Handbook*.

narrow for the Committee to consider in isolation, cannot be resolved efficiently within the confines of the existing Standards and *Conceptual Framework* and is better suited to be addressed as part of the Board's FICE project. We note that such a decision would be consistent with previous decisions of the Committee when an issue is being considered by the Board as part of an existing project. Appendix A to this paper sets out the proposed wording of the tentative agenda decision.

Questions 1 and 2 for the Committee

1. Does the Committee agree with our recommendation not to add a standard-setting project to the work plan?
2. Does the Committee have any comments on the proposed wording of the tentative agenda decision set out in Appendix A to this paper?

Appendix A—proposed wording of the tentative agenda decision

Accounting for warrants that are classified as financial liabilities on initial recognition (IAS 32 *Financial Instruments: Presentation*)

The Committee received a request about the reclassification of warrants applying IAS 32. Specifically, the request described a warrant that provides the holder with the right to buy a fixed number of equity instruments of the issuer of the warrant for an exercise price that will be fixed at a future date. At initial recognition, the variability in the exercise price results in the issuer classifying these instruments as financial liabilities, applying paragraph 16 of IAS 32. This is because for a derivative financial instrument to be classified as equity, it must be settled by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments ('fixed-for-fixed condition'). The request asked whether it is possible for the issuer to reclassify a warrant as an equity instrument following the fixing of its exercise price after initial recognition, given that the fixed-for-fixed condition would at that stage be met.

The Committee observed that there are no general requirements in IAS 32 for reclassifying financial liabilities and equity instruments after initial recognition when the instrument's contractual terms are unchanged. The Committee acknowledged that similar questions about reclassification arise in other circumstances. For this reason, reclassification by the issuer was identified as one of the practice issues the Board will consider addressing in its *Financial Instruments with Characteristics of Equity* (FICE) project. The Committee therefore concluded that the matter described in the request is, in isolation, too narrow for the Board or the Committee to address in an efficient manner and cannot be resolved efficiently within the confines of the existing Standards and the *Conceptual Framework*. Instead, the Board should consider the matter as part of its discussions on the FICE project. For these reasons, the Committee [decided] not to add a standard-setting project to the work plan.

Appendix B—Submission

We have reproduced the submission below.

…

Agenda Item Request: Derecognition of a warrant (IAS 32)

…

As a result of work carried out by national competent authorities and ESMA's coordination activities regarding financial information prepared in accordance with IFRS, ESMA has identified diversity in the application of the requirements of IAS 32 in relation to accounting for warrants that are initially classified as liability and then re-classified as equity.

Accordingly, ESMA kindly suggests that the IFRS Interpretations Committee (IFRS IC) considers clarifying the relevant accounting requirements. A detailed description of the case is set out in the appendix to this letter.

…

APPENDIX – DETAILED DESCRIPTION OF THE ISSUE

1. The terms and conditions of warrants or similar financial instruments may provide the holder with the right to buy equity instruments of the issuer of the warrants for an exercise price that will be fixed at a future date. When the issuer accounts for such warrants upon initial recognition, it has to apply the requirements in IAS 32 and to determine whether these instruments qualify as financial liabilities or equity instruments. The variability in the exercise price whose fixing is foreseen at a future date would generally result in a classification of these instruments as financial liabilities pursuant to paragraph 16 of IAS 32.
2. However, when the exercise price is subsequently fixed, some issuers have considered the possibility of derecognising the financial liability and recognising the warrants as equity instruments given that the fixed-for-fixed condition in IAS 32 would at this stage be met. In other words, some issuers believe that an accounting policy choice is available to re-classify the warrants as equity instruments.

3. As part of their monitoring and supervisory activities, ESMA and national enforcers have identified divergent application of the abovementioned requirements of IAS 32. ESMA understands that this issue might be present in multiple jurisdictions.

4. ESMA notes that IAS 32 does not provide explicit guidance with regard to whether an accounting policy choice is available to issuers to re-classify a financial liability if, as foreseen in the terms of the financial instrument, the price fixing occurs at a later stage and therefore the fixed-for-fixed condition would be met at that point in time. As a result, ESMA has observed that the following accounting policies have been developed on the basis of the accounting requirements of IAS 32:

    a. No re-classification of the warrant is admitted when a change in its features, that was already foreseen in its terms and conditions upon issuance, occurs after initial recognition (view 1);

    b. An accounting policy choice exists with regards to the re-classification of the warrant when a change in its features, that was already foreseen in its terms and conditions upon issuance, occurs after initial recognition (view 2); and

    c. A requirement exists under IFRS with regards to the re-classification of the warrant when a change in its features, that was already foreseen in its terms and conditions upon issuance, occurs after initial recognition (view 3)

View 1: No re-classification of the warrant is admitted when a change in its features, that was already foreseen in its terms and conditions upon issuance, occurs after initial recognition

5. Paragraph 15 of IAS 32 requires an issuer of a financial instrument to "*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*".

6. Paragraph 3.3.1 of IFRS 9 provides that: "*An entity shall remove a financial liability (or a part of a financial liability) from its statement of financial position when, and only when, it is extinguished—ie when the obligation specified in the contract is discharged or cancelled or expires*." Paragraph 3.3.2 further specifies that: "*a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability*".

7. Proponents of view 1 argue that no possibility is envisaged in IAS 32 to reclassify a financial instrument after initial recognition. In the fact pattern presented, the warrant was not subject to a substantial modification of its terms since the original terms of the warrants already envisaged that the fixing of the exercise price would occur at a future date.
8. Under this view, it is not possible neither to reclassify the instrument nor to derecognise it since the derecognition conditions in IFRS 9 are not satisfied. Proponents of this view, believe that the execution of one of the terms of the financial instrument, i.e. the postponed fixing of the exercise price of the warrant, neither constitutes an extinguishment of the liability nor a modification of the terms of the warrant.

View 2: An accounting policy choice exists with regards to the re-classification of the warrant when a change in its features, that was already foreseen in its terms and conditions upon issuance, occurs after initial recognition

9. On the other hand, proponents of view 2 consider that, following the fixing of the exercise price, the substance of the warrant has changed into that of an equity instrument since the warrant would then satisfy the fixed-for-fixed condition in IAS 32.
10. Therefore, under this view it would be misleading for users of financial statements to continue classifying the instrument as a financial liability even after the fixing of the exercise price.
11. Proponents of this view note that IAS 32 does not prevent an entity for re-assessing the nature of the financial instrument and its classification to reflect a change in facts and circumstances. Under this view, the entity would therefore be able to exercise an accounting policy choice and re-classify the instrument as an equity instrument following the fixing of the exercise price.

View 3: A requirement exists under IFRS with regards to the re-classification of the warrant when a change in its features, that was already foreseen in its terms and conditions upon issuance, occurs after initial recognition

12. Under view 3, the same arguments as to those indicated regarding view 2 would apply, but proponents of this view argue that it is required to reclassify the warrant given that the effective terms of the instrument have changed due solely to the passage of time.
13. Proponents of view 3 consider that the requirements in paragraph 3.3.1 of IFRS 9 for derecognition of a financial liability are met when due to the passage of time the features of

the warrant change into that of an equity instrument even if this situation was already envisaged as part of the terms of the financial instrument upon its issuance.

Request

14. ESMA seeks clarification on whether it is possible to reclassify a warrant as an equity instrument following the fixing of its exercise price which occurred, as foreseen at the issuance date in the terms of the instrument, after initial recognition when the instrument was classified as a financial liability.
15. ESMA observes that different views have been expressed regarding whether such re-classification is possible and whether entities have an accounting policy choice in this regard. Consequently, ESMA suggests that the IFRS IC clarifies the applicable requirements.