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STAFF PAPER

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Project	**Financial Instruments with Characteristics of Equity**	
Paper topic	The effects of laws on contractual terms—practice issues	
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Purpose of this paper

1. This paper and Agenda Paper 5F aim to facilitate the Board's initial discussion with respect to the effects of laws[1] on contractual terms of a financial instrument. In particular, the papers discuss whether and if so, to what extent, an entity should be required to treat a legal requirement or a feature that is required by law as part of the contractual terms of a financial instrument.

2. At this meeting, the staff seek the Board's view on the direction of the staff's future work. The staff will take into account comments and suggestions made by Board members and present proposals for the Board to decide on at a future Board meeting.

3. This paper sets out the practice problems and relevant requirements in IFRS Standards. Agenda Paper 5F of this meeting discusses potential approaches the Board could take to resolve the practice problems.

[1] In this paper, the term 'laws' and 'legal requirements' are intended to include statutes or regulations and statutory and regulatory requirements.

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Structure of the paper

4. This paper provides:
   (a) background;
   (b) practice question;
   (c) summary of the feedback on the 2018 FICE Discussion Paper;
   (d) related requirements in IFRS Standards;
   (e) staff analysis:
      (i) substance of contractual arrangement; and
      (ii) what contractual rights and obligations are created or affected by law?

Background

5. IFRS Standards on financial instruments have been developed to account for rights and obligations that arise from contracts. Both IAS 32 *Financial Instruments: Presentation* and IFRS 9 *Financial Instruments* were not meant to apply to rights and obligations that arise from laws.

6. The definitions of a financial instrument, a financial asset, a financial liability and an equity instrument in IAS 32 refer to contracts and contractual rights or contractual obligations. In so far as the meaning of 'contract' paragraph 13 of IAS 32 states that:

> In this Standard, 'contract' and 'contractual' refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing.

7. Applying IAS 32, assets and liabilities that are not contractual are not financial liabilities or financial assets. Paragraph AG12 of IAS 32 states the following:

> Liabilities or assets that are not contractual (such as income taxes that are created as a result of statutory requirements imposed by governments) are not financial liabilities or financial assets. Accounting for income taxes is dealt with in IAS 12. Similarly, constructive obligations, as defined in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, do not arise from contracts and are not financial liabilities.

8. In the context of this project, understanding the meaning of 'contractual' is a critical element of determining whether or not a financial instrument contains a contractual obligation that meets the definition of a financial liability and hence its classification as a financial liability or an equity instrument.

9. The term 'contractual' also affects other aspects of accounting for financial instruments. If the Board were to make any clarifications with respect to the meaning of contractual, it will have consequences on other aspects of the accounting for financial instruments in addition to the classification as financial liabilities or equity instruments. The consequences would include classification of financial assets and measurement of financial instruments, which are based on contractual cash flows. The analysis in this project would therefore need to consider any relevant implications for IFRS 9. Also, there may be consequences on the scope of the proposed disclosure requirements for contractual terms and conditions of particular financial instruments the Board discussed in April 2021.

10. Alternatively, the Board could focus solely on the classification as financial liabilities or equity as part of this project and state that any amendments the Board makes in relation to this topic solely relate to the classification as financial liabilities or equity, and not to other aspects such as classification of financial assets and measurement. In the staff's view however, such an approach would:

    (a) create a disconnect between the classification and other aspects of accounting such as measurement;

    (b) give rise to many interpretation or application questions; and

    (c) lead to diversity in practice.

Practice question

11. Questions arise in practice about the effect of laws on the rights and obligations arising from a contract (including, but not limited to, their enforceability). More specifically, the overarching question is whether, and if so to what extent, a legal requirement is part of the contractual terms and must therefore be considered in classifying a contract as a financial liability or an equity instrument. This question can be analysed into two parts:

    (a) whether a legal requirement that is reproduced or referred to in the contract is necessarily part of the contractual terms; and

    (b) whether a legal requirement that is not reproduced or referred to in the contract, but is implied by law is part of the contractual terms (ie whether the laws in a particular jurisdiction that affect the rights and obligations established in a contract should be considered as part of the contractual terms).

12. The staff acknowledge that all contracts are affected by law to some extent but practice questions stakeholders raise frequently relate to a limited number of financial instruments including those described in paragraphs 13–14 of this paper.

13. 'Bail-in' instruments—the most common example of this type of instrument is Additional Tier 1 capital instruments issued by banks to meet the regulatory capital requirements. Many of these are 'perpetual instruments' with obligations that arise only on liquidation of the issuer, which were discussed by the Board in February 2021. Banks are required by law to include a loss absorption feature in these instruments, either to be contingently convertible into ordinary shares of the issuer or written down, upon a trigger event linked to the capital ratio of the issuer. Stakeholders ask whether laws that impose a contingent conversion into ordinary shares or a write-down of the principal amount should be treated as part of the contractual terms and considered in classifying such instruments as financial liabilities or equity instruments.

14. Ordinary shares with statutory minimum dividends—the staff understand that in some jurisdictions, particular types of entities are required by law to distribute a minimum specified percentage of their profits as dividends to ordinary

shareholders. Stakeholders have asked whether that legal obligation to distribute a specified % of profit gives rise to a financial liability in itself, and if not, whether reproducing that legal requirement in the contract would make it part of the contractual terms and hence give rise to a contractual obligation that would meet the definition of a financial liability. If that is the case, stakeholders suggested an exception to allow equity classification similar to the exception for puttable instruments.

15. In all these examples, entities may arrive at different classification outcomes for the same financial instruments depending on whether the effects of laws are treated as part of the contractual terms.

Summary of the feedback on the 2018 FICE Discussion Paper

16. In the Discussion Paper *Financial Instruments with Characteristics of Equity* issued in 2018 (2018 DP), the Board discussed the relationship between contracts and law. The 2018 DP proposed no changes to IAS 32 on the topic. The Board's preliminary view was that an entity should apply the Board's preferred approach to *the contractual terms* of a financial instrument consistently with the existing scope of IAS 32 and IFRS 9.

17. More respondents agreed with the Board's preliminary view than disagreed. Some respondents who agreed with the Board's view noted that taking into consideration the overall effects of laws would represent a significant change to current requirements and could have unintended consequences.

18. However, most respondents (including those who agreed and disagreed with the Board's view) urged the Board to provide guidance on what should be considered as part of the contractual terms and whether, and how, an entity should consider the effects of relevant laws in classifying financial instruments, stating some deficiencies of a strict contract-only approach, including:

    (a) there is little difference between contractual obligations and legal obligations in terms of their economic effects. Focusing only on the contractual obligations leads to a risk that the substance of transactions is not fully reflected in the accounting. Some stakeholders

argue that contractual terms often only reflect issues that are not already governed by statutory law. Thus, considering only the contractual terms without considering statutory law might lead to different classification outcomes for two economically identical instruments, depending on the jurisdiction the issuing companies are incorporated in.

(b) contractual terms incorporate either directly or indirectly the provisions of applicable laws and regulations, and they cannot be considered independently of the legal environment. For example, a contract might specify under which law the contract operates or it might state that the entity is under the scope of specific legislation, provide a general reference to legislation or replicate the wording of the legislation. The enforceability of contractual terms depends on law.

(c) legal requirements can limit or otherwise affect the rights and obligations arising from the contract. In some jurisdictions statutory law takes precedence such that what is stated in the laws should also be deemed terms of the contract.

(d) inconsistency between the Board's preliminary views and approaches taken by other IFRS Standards and the Conceptual Framework for Financial Reporting (Conceptual Framework) (see paragraphs 21-30 of this paper).

19. Feedback from users of financial statements on the classification aspects of the 2018 DP was limited. However, a few users of financial statements agreed that laws and regulations should not affect classification of financial instruments as financial liabilities or equity instruments and acknowledged the practical challenges that would arise from reflecting the effects of law in the classification of financial instruments. They prefer disclosures of whether and how laws and regulations can affect settlement outcomes. Other users of financial statements recommended disclosures of all types of claims from all sources. They prefer a comprehensive disclosure of all claims over disclosure of only claims that arise

from contractual terms of financial instruments because they include all claims in their analyses.

20. At its October 2019 meeting, the Board tentatively decided to focus on addressing specific practice problems instead of introducing a new classification approach. One of the problems the Board plans to address is the effects of laws and regulations on the classification of financial instruments as financial liabilities or equity instruments. More specifically, the Board discussed exploring the following:

    (a) clarifying whether reproducing particular legal requirements in the contract make them part of the contractual terms and would therefore affect the classification; and

    (b) supplementing the principle by using illustrative examples to facilitate consistent application.

Related requirements in IFRS Standards

21. One of the defining aspects of all financial instruments is that their rights and obligations are contractual. As reproduced in paragraph 7 of this paper, paragraph AG12 of IAS 32 states that liabilities or assets that are not contractual are not financial liabilities or financial assets.

22. IAS 32, which defines financial instruments, makes reference to the law in the context of enforceability of a contract (see paragraph 6 of this paper). In addition, paragraph 15 of IAS 32 requires entities to classify financial instruments or its component parts 'in accordance with the substance of the contractual arrangement'.

23. Some IFRS Standards on financial instruments specify whether and how the relevant laws should be reflected in the accounting. Examples include the following:

(a) when offsetting a financial asset and a financial liability, IAS 32 requires an entity to consider the laws applicable to the relationship between the parties because the right of set-off is a legal right;[2]

(b) when an entity assesses the classification of a financial asset, IFRS 9 states that the entity would not include in its assessment of the contractual cash flows of a financial asset the payments that arise only as a result of the government or other authority's legislative power;[3]

(c) IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* states that for financial instruments within the scope of the Interpretation, the entity must consider all of the terms and conditions of the financial instrument in determining its classification as a financial liability or equity, including relevant local laws, regulation and the entity's governing charter in effect at the date of classification but not expected future amendments to those laws, regulations or charter.[4]

24. Paragraph 4.31 of Conceptual Framework states that:

> Many obligations are established by contract, legislation or similar means and are legally enforceable by the party (or parties) to whom they are owed. Obligations can also arise, however, from an entity's customary practices, published policies or specific statements if the entity has no practical ability to act in a manner inconsistent with those practices, policies or statements. The obligation that arises in such situations is sometimes referred to as a 'constructive obligation'.

25. Paragraph 4.60 of Conceptual Framework also states that:

> All terms in a contract—whether explicit or implicit—are considered unless they have no substance. Implicit terms could include, for example, obligations imposed by statute […].

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[2] Paragraph 45 of IAS 32

[3] Instrument E in paragraph B4.1.13 and paragraph BCZ4.60 of IFRS 9

[4] Paragraph 5 of IFRIC 2

26. Two recently issued Standards which apply to 'contracts' require an entity to consider the effects of laws in accounting for the rights and obligations arising from the contract. In assessing the existence and enforceability of a right to payment for performance completed to date, IFRS 15 requires an entity to consider the contractual terms as well as any legislation or legal precedent that could supplement or override those contractual terms.[5] In addition, IFRS 17 *Insurance Contracts* requires an entity to consider its substantive rights and obligations, whether they arise from a contract, law or regulation, and acknowledges that implied terms in a contract include those imposed by law or regulation.[6]

27. IFRS 16 *Leases* states that when determining the non-cancellable period of a lease, an entity considers all relevant facts and circumstances that create an economic incentive for the lessee to exercise the option to extend the lease, or not to exercise the option to terminate the lease.[7]

28. While many IFRS Standards address rights and obligations arising from a contract, some Standards address other rights and obligations. IAS 38 *Intangible Assets* says an asset is identifiable if it arises from contractual or other legal rights. In specifying the requirements around control, IAS 38 states that the capacity of an entity to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law.[8] IAS 37 defines a legal obligation as an obligation that derives from a contract (through its explicit or implicit terms), legislation or other operation of law.[9]

29. Although, not directly in the context of financial instruments accounting, the IFRS Interpretations Committee (the Committee) has also discussed issues related to contracts and laws. For example, in its September 2018 discussion on liabilities in relation to a joint operator's interest in a joint operation, the

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[5] Paragraph B12 of IFRS 15

[6] Paragraph 2 of IFRS 17

[7] Paragraph 19 of IFRS 16

[8] Paragraphs 12-13 of IAS 38

[9] Paragraph 10 of IAS 37

Committee noted that identifying the liabilities that a joint operator incurs and those incurred jointly requires an assessment of the terms and conditions in all contractual agreements that relate to the joint operation, including consideration of the laws pertaining to those agreements.

30. Another example of the Committee discussions related to contracts and laws was in March 2018 in relation to a question concerning revenue recognition in a real estate contract applying IFRS 15. In that case, the Committee concluded that the entity did not have an enforceable right to payment for performance completed to date, because the customer had the legal right to cancel the contract. In effect, the contractual terms were negated and set aside by the courts.

Staff analysis

31. Based on the definition of financial liabilities and equity instruments and the requirements in IAS 32, the staff think it is clear that the classification of financial instruments as financial liabilities or equity instruments is based solely on contractual terms. However, based on the feedback discussed above, the staff recognise that it will be key to understand (i) whether there is scope to read the references in IAS 32 to ‘contractual rights and obligations’ as wider than just explicit contractual terms and (ii) what is meant by the underlying principle in IAS 32 to classify a financial instrument in accordance with the ‘substance of the contractual arrangement’. This will be relevant to determining whether the applicable laws can be seen as part of the contractual terms, which needs to be considered in classifying financial instruments as financial liabilities or equity instruments.

32. The staff set out to:

    (a) understand what is meant by the ‘substance of the contractual arrangement’ (paragraphs 33–42);

    (b) examine how the contractual rights and obligations are affected by relevant laws (paragraphs 44–55);

    (c) establish the objectives and key considerations for developing potential principles (Agenda Paper 5F); and

(d) develop potential guiding principles to assist in an entity's classification analysis (Agenda Paper 5F).

Substance of contractual arrangement

33. As mentioned earlier in this paper, respondents to the 2018 DP highlighted the differences between the Board's preliminary views and approaches taken by other IFRS Standards and the Conceptual Framework in how the effects of laws are considered in accounting for financial instruments and other items. In this section the staff specifically focus on understanding what is meant by the 'substance of the contractual arrangement' in IAS 32 to understand whether 'contractual terms' can be read wider than just what is explicitly included in the contract.

34. Paragraph 15 of IAS 32 requires entities to classify financial instruments or its component parts 'in accordance with the substance of the contractual arrangement'. This paragraph has been referred to several times in the Committee's agenda decisions. For example, in September 2013 when discussing the classification of financial instruments that give the issuer the contractual right to choose the form of settlement, the Committee noted that paragraph 15 of IAS 32 requires the issuer of a financial instrument to classify the instrument in accordance with the substance of the contractual arrangement. Consequently, the issuer cannot achieve different classification results for financial instruments with the same contractual substance simply by describing the contractual arrangements differently.

35. Paragraph 13 of IAS 32 says 'contract' and 'contractual' refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Paragraph 18 of IAS 32 goes on to say that the substance of a financial instrument, rather than its legal form, governs its classification in the entity's statement of financial position. Substance and legal form are commonly consistent, but not always.

36. To understand more about the meaning of 'substance of the contractual arrangement', the staff considered some similar references in other IFRS Standards.

37. The Conceptual Framework discusses the concept of 'substance of contractual rights and contractual obligations' and refers to the economics of the contract. In particular, we note the following:

    (a) Paragraph 2.12 says 'To be useful, financial information must not only represent relevant phenomena, but it must also faithfully represent the substance of the phenomena that it purports to represent. In many circumstances, the substance of an economic phenomenon and its legal form are the same. If they are not the same, providing information only about the legal form would not faithfully represent the economic phenomenon'.

    (b) Paragraph 4.60 says 'All terms in a contract—whether explicit or implicit—are considered unless they have no substance. Implicit terms could include, for example, obligations imposed by statute, such as statutory warranty obligations imposed on entities that enter into contracts to sell goods to customers.

    (c) Paragraph 4.61 says terms that have no substance are disregarded. A term has no substance if it has no discernible effect on the economics of the contract. Terms that have no substance could include, for example: (a) terms that bind neither party; or (b) rights, including options, that the holder will not have the practical ability to exercise in any circumstances.

38. In the context of share-based payment transactions where an entity has the choice to settle in cash or by issuing equity instruments, paragraph 41 of IFRS 2 *Share-based Payment* explains that the entity has a present obligation to settle in cash if the choice of settlement in equity instruments has no commercial substance (eg because the entity is legally prohibited from issuing shares), or the entity has a past practice or a stated policy of settling in cash, or generally settles in cash whenever the counterparty asks for cash settlement.

39. From the above, it would appear that 'substance of the contractual arrangement' requires the following:

    (a) there must be existing contractual rights and obligations; and

    (b) terms that have economic or commercial substance ie a term must have an economic or commercial effect.

40. Furthermore, the Conceptual Framework would regard obligations imposed by statute as part of the terms of the contract whereas IAS 32 would not. The IAS 32 definition of contract merely considers whether the economic consequences arising from agreement between the parties are enforceable by law rather than including obligations imposed by law.

41. The question therefore arises as to whether the focus of the classification assessment in IAS 32 should be on rights and obligations (that have economic and commercial substance):

    (a) regardless of whether they arise from terms that are explicitly included in the contract; or

    (b) that only arise from terms that are explicitly included in the contract.

42. The Board could consider whether focusing only on explicit contractual obligations leads to a risk that the accounting does not fully reflect the substance of transactions. As highlighted by some respondents, there is often little difference between contractual obligations and legal obligations in terms of their economic effects. In addition, in some jurisdictions contractual terms often only reflect issues that are not already governed by statutory law. Thus, considering only the explicit contractual terms without considering statutory law might lead to different classification outcomes for two economically identical instruments depending on the jurisdiction the issuing companies are incorporated in.

What contractual rights and obligations are created or affected by law?

43. In this section, the staff examine, for financial instruments described in paragraphs 13–14 of this paper, what types of rights and obligations are created or affected by law so that we can use that understanding for the discussion in Agenda Paper 5F of this meeting.

Bail-in instruments

44. The most commonly raised practice issue by respondents in this area related to financial instruments with bail-in provisions, eg Additional Tier 1 capital instruments (AT1 instruments) issued by banks. Banks issue these instruments because these instruments are eligible to be counted towards the banks' regulatory capital for capital adequacy regulatory purposes. Such eligibility depends upon a number of conditions being satisfied, one of which relates to the ability of the instruments to absorb any losses of the bank.

45. Stakeholders have asked whether:

    (a) such contingent conversion or write-down features are part of the contractual terms and should be considered in classifying the instruments as financial liabilities or equity instruments;

    (b) reproducing the relevant legal requirements in the contract makes them part of the contractual terms; and

    (c) the conclusion would differ if such a reference to legal requirements is dynamic (the reference is made in such a way that ensures the contract refers to the *currently effective* legal requirements should the legal requirements be amended in the future) or static (a simple reproduction of legal requirements that may become out of date if the legal requirements are amended).

46. Stakeholders have told us that when a bank issues a bail-in instrument in a domestic market, the banking resolution regulation may not be explicitly included in the contract as it is widely understood that it applies by law in the issuing jurisdiction. On the other hand, when the bank issues a similar instrument in a foreign market where the banking resolution regulation does not apply in the same way, the details of the regulation are included in the contract ie the contractual terms replicate what the law prescribes in the domestic market. This is done so that investors in the instruments issued in the foreign market understand the regulatory requirements the issuing bank is subject to and not because the instruments are different to those issued in the domestic market. The question that arises is therefore whether the terms added to the instruments

issued in the foreign market to replicate the relevant regulation, should be treated as part of the contractual terms.

47. The staff reviewed the contracts of a number of AT1 instruments to understand how the contractual rights and obligations are affected by relevant laws. We note that the contracts include two types of bail-in provisions, one that is specific to the instrument (paragraphs 48–49 of this paper) and the other that is more of a general nature (paragraphs 50–51 of this paper). The staff note that the issuer does not have a contractual obligation to redeem these instruments unless the issuer exercises a call option or the issuer is liquidated and it does not have a contractual obligation to pay coupons. The contract gives the issuer the right to, at its sole discretion, cancel payment of interest, in whole or in part, on any interest payment date on a non-cumulative basis.

48. All AT1 instruments include a loss absorption provision specific to the instrument. For ease of reference, we will refer to this as a ‘specific loss absorption feature’ in this paper and in Agenda Paper 5F. Some instruments require the notional amount of the instruments to be written down on the occurrence of a trigger event while others require the instruments to be converted into ordinary shares of the issuer. The trigger event was typically defined as the common equity tier 1 capital ratio pursuant to the relevant regulation falling below 5.125 per cent in some and 7 per cent in others. The instruments with a contingent conversion provision included a specific conversion price and whether it is subject to any adjustments such as anti-dilution adjustments.

49. The requirement for the AT1 instruments to include a specific loss absorption feature stems from the legal requirements. A contingent write-down feature limits the issuer’s obligations to repay the principal amount of the instrument at liquidation of the issuer while a conversion feature creates a contingent obligation for the issuer to convert the instrument into a fixed number of own shares or a variable number of own shares.

50. In addition to the specific loss absorption feature, all AT1 instruments reviewed stated in the contract that they are subject to the exercise of the bail-in power by the Relevant Resolution Authority. For ease of reference, we will refer to this as

the 'general bail-in power' in this paper and Agenda Paper 5F. The exercise of a bail-in power is described as including a broad range of possible actions such as:

(a) write down, including writing down to zero, the claims for payment of the principal amount, the interest amount or any other amount in respect of the instrument;

(b) convert these claims into ordinary shares of (i) the Issuer or (ii) any group entity or (iii) any bridge bank or other instruments of ownership qualifying as Common Equity Tier 1 instruments; and/or

(c) apply any other resolution measure, including, but not limited to, (i) any transfer of the Notes to another entity, (ii) the amendment, modification or variation of the Terms and Conditions of the Notes or (iii) the cancellation of the Notes.

51. The general bail-in power therefore creates a contingent obligation for the issuer to convert the instruments into an unspecified number of own shares or shares of another entity, or to comply with any other resolution measure decided on by the regulator.

52. Furthermore, many contractual provisions are subject to the approval of the relevant regulator. For example, the redemption of the instruments is subject to the regulator's approval and the regulator has the power to prohibit the issuer from paying interest on the instruments. In addition, the regulator may fail to approve or withdraw approval of the issuance of conversion shares following a trigger event.

53. The classification outcomes of the bail-instruments would be affected by whether or not the bail-in provisions are treated as part of the contractual terms:

(a) if the general bail-in power were to be treated as part of the contractual terms, all bail-in instruments would be classified as financial liabilities (at least in part).

(b) if the specific loss absorption feature were to be treated as part of the contractual terms, the classification outcome would differ depending on the type of the specific loss absorption feature. If a loss absorption feature requires a conversion into a fixed number of own shares or

requires a write-down, the instrument would be classified as an equity instrument. If it requires a conversion into a variable number of own shares, the instrument would be classified as a financial liability.

Ordinary shares with statutory minimum dividends

54. As explained in paragraph 14 of this paper, a legal requirement in some jurisdictions creates an obligation for the issuer of ordinary shares to distribute a particular % of its future profits as dividends. Stakeholders noted that an instrument which explicitly mirrors statutory requirements in the contract could be economically identical to an instrument which is affected by the law but does not specify those terms in the contract. If a contract (rather than a law) obliges the issuer to distribute a specific % of profit to the holder, such an obligation meets the definition of a financial lability.

55. The issue becomes more complex when entities in those jurisdictions that are required by law to distribute a minimum percentage, say 10% of their profits as dividends, include additional obligations in the contract to pay a percentage of profits over the statutory minimum, say an additional 5%. The question arises whether the financial liability represents the excess over the statutory minimum (ie 5% of the profit) or all the amounts that the entity is required to pay (ie 15% of the profit).

56. In Agenda Paper 5F, the staff will use these instruments to illustrate potential approaches the Board could take to develop principles that will help resolve practice questions.