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Project	**Financial Instruments with Characteristics of Equity**
Paper topic	The effects of laws on contractual terms—potential solutions

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Purpose of this paper

1. This paper continues the staff analysis from Agenda Paper 5E of this meeting and contains the staff's preliminary views and a question for the Board.

Structure of the paper

2. This paper provides:
   - (a) staff analysis:
     - (i) objectives and key considerations for developing potential principles;
     - (ii) potential guiding principles;
     - (iii) alternative approaches considered;
     - (iv) mandatory tender offers;
     - (v) disclosures;
   - (b) staff's preliminary views and next steps; and
   - (c) question for the Board.

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Staff analysis

Objectives and key considerations for developing potential principles

3. The overarching goal of this project is to improve the information provided to users of the financial statements about financial instruments issued. In October 2019, the Board decided to achieve this by addressing specific practices issues that arise when applying IAS 32 and enhancing presentation and disclosure requirements.

4. Consistent with the overarching goal of this project, the staff have considered the following objectives in developing potential principles that could address the practice problems relating to the effects of law on contractual terms :

   (a) reduce diversity in practice by providing guiding principles that would enable entities to determine whether the applicable laws are part of the contractual terms, and therefore should be considered in classifying financial instruments as financial liabilities or equity instruments.

   (b) improve the comparability of the financial statements by requiring consistent classification for economically similar financial instruments. If laws affect the existing rights and obligations in a contract, there are clear economic consequences for the entity. If those economic consequences are similar to those that would arise if the rights and obligations were contractually agreed, then ideally, they would be accounted for similarly.

   (c) consider whether any additional disclosure requirements are needed.

5. In the October 2019 meeting, the Board discussed addressing practice issues by clarifying the underlying principles in IAS 32 and developing a principle where there is not an implicit or explicit principle in IAS 32. Also, the Board decided to address practice issues without fundamentally changing the requirements in IAS 32.

6. Given the variety of contracts and the applicable laws, it is unlikely that one simple principle will provide a clear answer in every case. The staff expects that entities would need to analyse relevant facts and circumstances for individual contracts, or for each type of contract, to determine whether the applicable laws

are part of the contractual terms, and therefore should be considered in classifying financial instruments as financial liabilities or equity instruments. The staff think that the Board could develop guiding principles that support entities in making their analyses.

7. In its October 2019 meeting, the Board noted that some questions are by nature more difficult to resolve without fundamentally reconsidering the requirements in IAS 32 and so would be outside the scope of this project. An example the Board discussed in that meeting was mandatory tender offers ('MTOs'). This is when an entity acquires a specified level of shareholding in another entity, laws in many jurisdictions require the acquirer to offer to purchase some or all outstanding shares of the acquiree held by the other shareholders. The question that arises in practice is whether the legal requirement to make an offer should result in recognition of a liability when the acquirer acquires a specific level of shareholding in the acquiree. In this paper, the staff will consider whether the proposed guiding principles can be used to analyse whether MTOs represent contractual obligations at the date the acquirer acquires a specified level of shareholding in the acquiree and if so, should be recognised as a financial liability (see paragraphs 49–52 of this paper). However, the staff continue to believe that addressing all other aspects of accounting for MTOs would require a fundamental change to IAS 32 and doing so therefore would be outside the scope of this project.

8. We would like to caution that the guiding principles are intended to help identify the contractual rights and obligations that an entity considers when determining the classification of financial instruments as financial liabilities or equity. The conclusion that a right or an obligation is not contractual does not mean an entity need not account for it. An entity is required to consider the requirements in other IFRS Standards as applicable to determine if a non-financial asset or a non-financial liability should be recognised.

9. In developing these principles, consideration should be given to how widely they can be applied. Some stakeholders highlighted practical challenges that arise from having subsidiaries located in many different jurisdictions with different legal environments. Therefore, developing a set of guiding principles that could apply

irrespective of the specific legal environment, would ensure that economically similar instruments are classified consistently.

Potential guiding principles

10. Considering the objectives discussed in paragraphs 3–9 of this paper, the staff explore a number of potential guiding principles to help determine whether legal requirements or terms that are required by law should be regarded as part of the contractual terms regardless of whether a term is explicitly stated in the contract, and should be considered in classifying a financial instrument as a financial liability or an equity instrument.

11. The staff envisage the principles to work as a package and would apply in sequence. Each principle is aimed at answering different aspects of the practice questions described in Agenda Paper 5E. In this section, we set out the rationale behind each guiding principle and its scope, and illustrate how the principle would apply in classifying the following example instruments:

    (a) bail-in instruments that is:

        (i) is automatically converted into a fixed number of ordinary shares upon the issuer breaching a specified capital ratio (specific loss absorption feature); and

        (ii) is subject to the general bail-in power of the relevant regulator as described in Agenda Paper 5E;

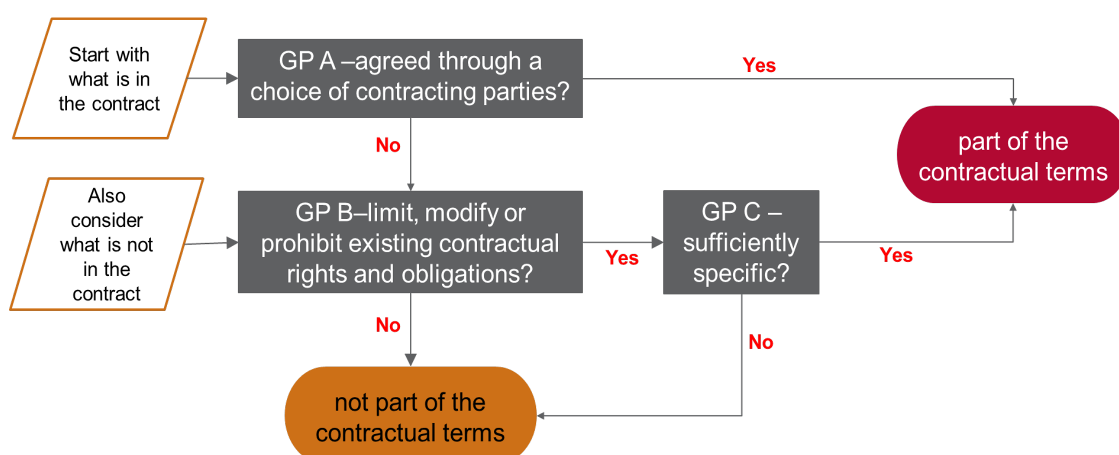
    (b) ordinary shares on which the law requires the issuer to pay a minimum 10% of its profit as dividends;

    (c) ordinary shares that are subject to the same legal requirement as paragraph 11(b) but for which the contract requires the issuer to pay 15% of its profit as dividends; and

    (d) puttable financial instruments whose redemption is unconditionally prohibited by local law. These instruments are currently in the scope of IFRIC 2 and subsequently referred to as 'IFRIC 2-type instruments' in this paper.

12. The staff would like to make it clear that the reason why we illustrate how the principles would apply to IFRIC 2 instruments is not because stakeholders are questioning the conclusions in IFRIC 2. It is rather because stakeholders often refer to IFRIC 2 instruments as an example of a situation in which classification of financial instruments considers the effects of relevant laws. The staff's intention is to see how the proposed guiding principles would apply to these types of instruments.

13. The following diagram is an overview of the order in which the staff expect the guiding principles to apply. The detailed information is provided in the rest of this section and the staff analysis follows this order:



Guiding principle A—are the terms negotiable and agreed through a choice of contracting parties?

Rationale

14. Firstly, the staff set out to understand what a contract means from a legal perspective and use that understanding to distinguish contractual terms from legal requirements. Contract law is a branch of private law. It thus concerns private obligations that arise in respect of symmetrical relations among natural and artificial persons rather than public obligations that arise in respect of hierarchical relations between persons and the state. Contracts are created through offer, acceptance and consideration. A contract is distinctive in that it represents chosen,

or voluntary, obligations—that is, obligations constituted by the intentions of the contracting parties.[1]

15. One of the important principles of contract law is autonomy. Entities are free to choose to contract and on any terms they choose. They may allocate risks within their contracts as they wish. It is up to the parties to decide what risks they will accept and on what terms.[2]

16. The staff think the Board could develop a principle that is based on the notion of autonomy of contracting parties. A contractual obligation is an obligation assumed by an entity by its choice. Therefore, the principle may be based on the fact that a term is part of the contractual terms if it is subject to a negotiation between parties to the contract to determine the specifics. On the other hand, legal obligations are those that arise from law, are generally not specific to the entity and the instrument and is not subject to negotiation between parties to the contract.

Scope

17. This principle is aimed at answering the question as to whether all the terms explicitly stated in the contract should be treated as part of the contractual terms. The principle would apply to terms that are derived from or required by law and that are explicitly stated in the contract.

18. Guiding principle A would treat only those terms that go beyond, or in addition to, the legal requirements and are therefore subject to negotiation between the contracting parties as part of the contractual terms.

19. In other words, terms implied by law and that would have applied to an instrument regardless of whether they were explicitly stated in the contract, are not part of the contractual terms. For example, if a law in a particular jurisdiction obliges all companies to distribute a particular percentage of profits as a dividend, a company would have the obligation to pay dividends regardless of whether the company states that in the contract (shareholders' agreement in this case). Therefore, for a term to be treated as part of the contractual terms, it needs to

[1] https://plato.stanford.edu/entries/contracts-theories

[2] Legally Binding Contracts & Terms: Basics of Contract Law (hallellis.co.uk)

create rights or obligations that are in addition to or different from the legal rights and obligations.

20. In applying this principle, an entity may ask the following questions about a particular term:

    (a) would the term apply in the same way even if it is not reproduced in the contract?

    (b) is it possible for contracting parties to negotiate the specifics of the term?

    (c) does the term create rights and obligations that are 'stricter' or 'more specific' than what is required by law?

21. The ‘yes’ answer to the question in paragraph 20(a) of this paper would indicate that the requirement is not part of the contractual terms. The ‘yes’ answer to the questions in paragraphs 20(b) and 20(c) of this paper would indicate that the requirement is part of the contractual terms.

Application to the examples

22. For bail-in instruments described in paragraph 21 of this paper, the staff analyse the application of the principle to the specific loss absorption feature and general bail-in power separately.

23. The specific loss-absorption creates specific rights and obligations. For example, the issuer would set the trigger point (provided that it is above the minimum required % of capital)[3] and would set the conversion price, if convertible. Such a feature may stem from a legal requirement, but it is specific to each financial instrument and agreed between the contracting parties by choice. Specific loss absorption features therefore create contractual rights and contractual obligations that are in addition to or more specific than the legal rights and obligations.

[3] For example, Article 54 of Capital Requirements Regulation (CRR) states that a trigger event in an AT1 instrument occurs when the Common Equity Tier 1 capital ratio of the institution falls below either (i) 5.125% or (ii) a level higher than 5,125 %, where determined by the institution and specified in the provisions governing the instrument. It permits institutions to specify in the provisions governing the instrument one or more trigger events in addition to this. CRR is a regulation that implements BASEL III in the EU and includes prudential requirements for financial institutions and financial holding companies.

24. In contrast, a bank's capital instrument is also subject to the general bail-in power as described in Agenda Paper 5E and the contract may include a description of what such bail-in power entails. Applying this guiding principle in paragraph 18, the entity would not treat the general bail-in power as part of the contractual terms because the parties to the contract do not have a choice to amend or reject this term if they were to issue and invest in such a capital instrument. For that reason, such a term would be treated as non-contractual and would not affect the classification of an instrument as a financial liability or equity even if they are included in the contract. However, the term might still result in legal rights and legal obligations that are accounted for applying other IFRS Standards.

25. As another example, if a law in a particular jurisdiction specifies that all companies in that jurisdiction must pay at least 10% of profit as dividends to ordinary shareholders, the parties to the contract do not have a choice but to accept the requirement as is. This is regardless of whether the requirement is included in the contract. In contrast, if an entity in such jurisdiction enters into a contract that specifies the issuer has to pay 15% of profit, the contractual term is created through a choice of contracting parties and the entire obligation to distribute 15% of future profits would be treated as a contractual term.

26. Some may argue that the general bail-in power is also a result of the entity choosing to issue a particular type of financial instrument. The entity could have chosen to issue a plain vanilla bond instead of a capital instrument and in that case, the entity would have avoided having the bond subject to the general bail-in power. Similarly, some may make the same argument for ordinary shares that are subject to the minimum percentage dividend requirement. The entity could have chosen not to issue ordinary shares and instead issue some other form of equity instruments. The staff think that an entity should perform the analysis of what terms are subject to an agreement through choice within the context of a particular type of instrument. In other words, the analysis is not about whether the entity can choose to issue a particular type of instrument but is about which terms and conditions the entity can choose for the instrument that it decides to issue.

27. With regards to an IFRIC 2-type instrument, an entity that chooses not to include in the contract that the redemption is subject to a legal prohibition, would not need to apply this principle. This is because the starting point for Guiding Principle A,

is to look at the terms that are explicitly stated in the contract. However, if the entity chooses to state the legal prohibition explicitly in the contract, the entity would need to apply the principle. In doing that, the entity would conclude that the legal prohibition is not part of the contractual terms because it does not create an additional right or obligation beyond the legal requirements. In addition, the legal prohibition would apply regardless of whether it is included in the contract or not. Guiding Principle B (see paragraphs 29–40) would apply to both of these IFRIC 2-type instruments because the legal prohibition limits the contractual obligation.

28. In summary, the following would be the result of applying Guiding Principle A in isolation to the example instruments described in paragraph 11 of this paper:

(a) Specific loss absorption feature in the bail-in instrument—part of the contractual terms;

(b) General bail-in power in the bail-in instrument—not part of the contractual terms when applying Guiding Principle A in isolation. Continue the assessment by applying Guiding Principle B;

(c) Ordinary shares with statutory minimum dividends—not part of the contractual terms when applying Guiding Principle A in isolation. Continue the assessment by applying Guiding Principle B;

(d) Ordinary shares with dividends above the statutory minimum dividends—part of the contractual terms; and

(e) IFRIC 2-type instruments—not part of the contractual terms when applying Guiding Principle A in isolation. Continue the assessment by applying Guiding Principle B.

Guiding principle B—Do laws limit, modify or prohibit an existing right and obligation in a contract?

Rationale

29. Some legal requirements may limit, modify or prohibit existing rights and obligations in a contract. As described in Agenda Paper 5E of this meeting, IAS 32 describes ‘contract’ or ‘contractual’ to refer to an agreement that parties

have little, if any, discretion to avoid, usually because the agreement is enforceable by law.

30. The staff is of the view that if a law affects an existing right or obligation in a contract in a way that permits or requires the contracting parties to avoid such an obligation or makes it unenforceable in its original form, the effects of such law have to be considered part of the contractual terms. This means that under Guiding Principle B, an entity would take into account the effects of such laws in classifying financial instruments as financial liabilities or equity instruments. In the staff's view, this would help better reflect the substance of the contractual arrangement in classifying the financial instruments.

31. This principle is similar to the logic used in IFRIC 2. Paragraph 8 of IFRIC 2 states that:

> Local law, regulation or the entity's governing charter can impose various types of prohibitions on the redemption of members' shares, eg unconditional prohibitions or prohibitions based on liquidity criteria. If redemption is unconditionally prohibited by local law, regulation or the entity's governing charter, members' shares are equity. […]

32. Guiding Principle B is based on the fact that the contract terms cannot contradict or go against the law but that law can contradict the contractual terms, eg legal restrictions on share issuances. It is also focusses on whether a contractual term is limited, modified or prohibited and not on whether a new obligation, that does not exist already, is created. It therefore distinguishes between when legal requirements affect existing rights and obligations in the contract and when legal requirements create new rights and obligations.

Scope

33. Guiding Principle B is aimed at answering the question of whether particular legal requirements, that may or may not be stated in the contract, are part of the contractual terms. Said another way, it considers whether the contractual terms should be read wider than just the explicit contractual terms. The staff's preliminary view is that this principle should apply to legal requirements that are

not stated in the contract and the terms that are stated in the contract but have been determined to be not part of the contractual terms applying Guiding Principle A.

Application to the examples

34. In the example of the bail-in instruments described in paragraph 11 of this paper, Guiding Principle B would not apply to the specific loss absorption feature because it has already been determined to be part of the contractual terms under Guiding Principle A.

35. However, the general bail-in power was determined to be not part of the contractual terms under Guiding Principle A and therefore needs to be assessed under Guiding Principle B. The general bail-in power modifies the obligation to repay the principal amount at liquidation of the issuer. Therefore, when triggered, the issuer has an obligation to perform the action the regulator requires instead of repaying the instrument at liquidation of the issuer. Applying Guiding Principle B, the general bail-in power would thus be treated as part of the contractual terms.

36. Similarly, for an IFRIC 2-type instrument whose redemption is prohibited by law, the legal requirement prohibits an existing contractual obligation ie the issuer's obligation to redeem the instrument. The legal requirements make the redemption obligation unenforceable and when applying Guiding Principle B, such a legal prohibition would be treated as part of the contractual terms. For the avoidance of doubt, for a law to negate a contractual obligation for classification purposes, the law must unconditionally prohibit the contractual obligation. This is consistent with IAS 32 in that an entity needs to have an unconditional right to avoid an obligation to conclude that the obligation does not meet the definition of a financial liability.

37. In contrast, the legal requirement for a company to distribute a minimum of 10% of its profit as dividends creates a new obligation rather than limiting, modifying or prohibiting a right or obligation existing in the contract (shareholders' agreement). Therefore, such an obligation would not be treated as part of the contractual terms because even though there might be an existing shareholders agreement, there is no existing obligation in the contract that is being limited, modified or prohibited.

38. The staff acknowledge that the distinction between whether a legal requirement limits, modifies or prohibits an existing contractual right or obligation and whether it creates a new right or obligation may be subtle. The question may arise in applying this guiding principle about where to draw the line. For example, some may argue that the legal requirement to distribute a minimum percentage of profit as dividends may be seen as modifying the terms of the shareholder agreement between the entity and the shareholder. However, the staff think it is important to establish if there are existing rights and obligations in the contract that are being affected rather than only focusing on whether there is an existing contract.

39. As another example, some might argue that there is a legal obligation on management to act in the best interest of the entity and exercise its fiduciary duties which may affect the evaluation of whether a liability exists. It would be important to phrase this principle unambiguously and to supplement it with illustrative examples so that it is not open to abuse or particular structuring to achieve an accounting classification outcome.

40. In summary, the following would be the result of applying Guiding Principles A and B to the example instruments described in paragraph 11 of this paper:

    (a) Specific loss absorption feature in the bail-in instrument—part of the contractual terms;

    (b) General bail-in power in the bail-in instrument—part of the contractual terms. Continue the assessment by applying Guiding Principle C;

    (c) Ordinary shares with statutory minimum dividends— not part of the contractual terms;

    (d) Ordinary shares with dividends above the statutory minimum dividends—part of the contractual terms; and

    (e) IFRIC 2-type instruments—part of the contractual terms. Continue the assessment by applying Guiding Principle C.

Guiding principle C—Are the terms sufficiently specific to allow reasonable determination of contractual rights and obligations?

Rationale

41. Rights and obligations created by a contract and those created by laws often differ in specificity. For example, as explained in Agenda Paper 5E, AT1 instruments are subject to the general bail-in power in which the relevant regulator has the power to impose losses using one or more of various measures. It is likely difficult for an entity to determine the specific rights and obligations they might have because they are subject to the regulator's discretion.

42. It should be noted that a difficulty in measurement and a difficulty in determining rights and obligations are not the same thing. For example, it may be difficult to measure a financial instrument puttable in x number of years at the fair value of pro-rata net assets of the issuer, but the issuer's obligation is clearly defined as the fair value of its pro-rata net assets at a specified point in time.

Scope

43. The staff think this principle may be used as a supplementary principle in addition to Guiding Principles A and B to help ensure the financial reporting consequences of applying those principles result in useful information, eg applying it as a final step to determine whether a legal term or requirement should indeed be treated as part of the contractual terms.

44. The staff's current view is that it would apply only in one direction, ie only apply to those rights and obligations that have been determined as part of the contractual terms applying Guiding Principle B. This is because when a legal requirement external to the contract might be regarded as part of the contractual terms, the need arises to consider the usefulness of information resulting from classifying those additional obligations as a financial liability. More specifically, Guiding Principle C would preclude classifying obligations that cannot readily be determined as a financial liability. It would not apply to what has been determined as contractual applying Guiding Principle A because Guiding Principle A already indirectly considers the specificity of the rights and obligations, removing the need to apply Guiding Principle C.

45. Alternatively, the Board could combine Guiding Principles B and C as one principle. The principle could then be expressed as whether a legal requirement limit, modify or prohibit existing contractual rights and obligations in a way that is specific enough to allow reasonable determination of contractual rights and obligations. It would remove the need to have this final step while achieving the same results. However, it would mean Guiding Principle B would have more than one step, increasing the complexity. The staff have therefore kept them as two separate principles.

Application to examples

46. Applying this principle to the bail-in instruments, the general bail-in power would not be considered as part of the contractual terms because the issuer's obligation is not defined with sufficient specificity to allow a reasonable determination of the entity's contractual rights and obligations.

47. In contrast, the legal prohibition for the redemption of the IFRIC 2-type instruments would be considered as part of the contractual terms because it is specific enough to allow reasonable determination of the issuer's contractual obligation or lack thereof.

48. In summary, the following would be the classification outcomes of applying Guiding Principles A, B and C to the example instruments described in paragraph 10 of this paper:

   (a) Bail-in instrument—equity instrument (The specific loss absorption feature is a contractual term but the general bail-in power is not);

   (b) Ordinary shares with statutory minimum dividends—equity instruments;

   (c) Ordinary shares with dividends above the statutory minimum dividends—financial liability; and

   (d) IFRIC 2-type instruments—equity instruments.

Mandatory tender offers

49. The IFRS Interpretations Committee (the Committee) and the Board have previously discussed the inconsistency between the accounting for MTOs and the

accounting for written put options on non-controlling interests (NCI puts). IAS 32 contains requirements to recognise a financial liability for NCI puts. However, in practice a liability for MTOs is not recognised either because entities argue that an MTO is not within the scope of IAS 32 or is excluded from IAS 37 because it is an executory contract. The requirement to make an offer to NCI shareholders that arises from an MTO could be seen as effectively creating an NCI put because the NCI shareholder has a right to sell its shares which is enforceable by law.

50. Although the staff have previously said, and continue to believe, that comprehensively addressing the accounting for MTOs (including for example, considering their measurement and presentation) is outside the scope of this project, the staff believe that application of the Guiding Principles could assist in determining whether MTOs represent contractual obligations at the date the acquirer obtains control of (or a specified level of shareholding in) the acquiree. At that point, the acquirer is required by law to make an offer to the remaining shareholders. Therefore, we need to consider whether that legal requirement should be treated as part of the contractual terms.

51. One view is that there is no contract between the acquirer and the non-controlling interest at this point in time. Guiding Principle A would not apply because there is no contract. Under Guiding Principle B, an entity would conclude that the legal requirement to make an offer is not part of the contractual terms because it does not affect any existing contractual rights and obligations.

52. An alternative view considers that there is a contract, ie the shareholders' agreements between the consolidated entity (that is now controlled by the acquirer) and the non-controlling interest holders. The shareholders' agreement contains no contractual obligation relating to redeeming the shares held by the non-controlling interest holders. Guiding Principle A would not apply because there is no explicit redemption obligation in the contract. Applying Guiding Principle B, an entity would conclude that MTOs are not part of the contractual terms because the MTOs do not limit, modify or prohibit any existing contractual rights and obligations in the contract. Regardless of which view an entity takes, applying the guiding principles, an entity would conclude the legal requirement to make an offer is not part of the contractual terms.

Alternative approaches considered

53. As part of the process of developing potential guiding principles, the staff considered other approaches but do not recommend the Board explore these further for the reasons explained in this section.

Alternative approach X—All-inclusive approach

54. Similar to some other IFRS Standards that consider both contractual and legal terms (see Agenda Paper 5E of this meeting), this approach takes a view that:
    (a) all terms explicit in the contracts are part of the contractual terms because they have been agreed to by the parties to the contract; and
    (b) implied terms are also part of the contractual terms because they are legally binding.

55. The terms of a contract include explicit terms and implied terms. Implied contract terms are items that a court will assume are intended to be included in a contract, even though they are not expressly stated in the contract. Terms are implied, either because the parties intended this, or by operation of law, or by custom or usage.

56. Applying this principle, both explicit and implied terms would be considered to be part of the contractual terms. Therefore, all financial instruments that are subject to a general bail-in power feature would be classified as financial liabilities, at least in part, because the actions regulators can take against the issuer would be treated as contractual and some of them would meet the definition of a financial liability (eg obligation to convert the instrument into an unspecified number of shares). In the case of ordinary shares with statutory minimum dividends, the shares would be classified, at least in part, as a financial liability because the obligation to pay a minimum percentage of future profit would be treated as a contractual obligation and would meet the definition of a financial liability. The IFRIC 2-type instruments would be classified as equity instruments because the legal prohibition to redeem the instruments would be treated as a contractual term and negate the obligation to redeem the instruments per the contract.

57. The staff note that in paragraph BC9 of IAS 32, when explaining the retention of the notion of 'indirect obligations' from the previous version of IAS 32, it is specifically mentioned that the Board did not debate whether an obligation can be

established implicitly rather than explicitly because it was not within the scope of the project the Board was then working on.

58. The staff do not recommend the Board further explore this approach because doing so would represent a fundamental change to the definition of financial instruments as well as to the IAS 32 classification approach as a financial liability or equity. The staff think such a fundamental change is beyond the scope of this project. Furthermore, this approach is not consistent with the approach taken in IFRS 9 for assessing the contractual cash flows characteristics of financial assets. In particular, the staff note the example in paragraph B4.1.13 of IFRS 9 (Instrument E) which illustrates that payments that arise only as a result of the national resolving authority’s power to impose losses on the holders are not contractual terms of the instrument. The staff do not envisage that the benefits of applying this approach would outweigh the costs of identifying all implied terms and changes to them and accounting for them applying the requirements in financial instrument IFRS Standards such as IAS 32 and IFRS 9.

Alternative approach Y—Will a term apply to the contract even if the law changes in the future?

59. This approach distinguishes contractual terms based on the way a term that is required by law or a legal requirement itself is reproduced or referred to in the contract. A term or a legal requirement would be considered to be part of the contractual terms of a financial instrument (and therefore be considered in determining its classification) if it would continue to apply throughout the life of the instrument despite subsequent changes in laws. In practice, this is commonly referred to as a ‘static term’ or ‘static reference’ because it remains the same despite future changes in laws. In contrast, a term or a legal requirement included in the contract would not be considered part of the contractual terms if it would automatically change to reflect future changes in the statutory or regulatory requirements. In practice this is commonly referred to as a ‘dynamic term’ or ‘dynamic reference’ because it is updated as laws are changed unilaterally by the government.

60. However, in some cases it may not be clear from the contract what the impact of a change in law will be and therefore whether a term is static or dynamic. For

example, the staff came across a prospectus that stated: "The Conditions, (except for Conditions 3 and 6 of each Series of Notes (which are based on [Country Y] law in effect as at the date of issue of the relevant Series of Notes)) are based on English law in effect as at the date of issue of the relevant Series of Notes. No assurance can be given as to the impact of any possible judicial decision or change to English law or administrative practice or [Country Y] law or administrative practice, as the case may be, after the date of issue of such Series of Notes".

61. Applying this principle to bail-in instruments subject to the general bail-in power, they would be classified as financial liabilities, at least in part, if the reference to the law is static but classified as equity instruments if the reference to the law is dynamic. We recognise that a static term could create rights and obligations that are different from law because it stays the same even if the law changes subsequently. However, in the staff's view, Guiding Principle A already incorporates this rationale and does so in a more holistic manner. Furthermore, just because a term is dynamic does not necessarily mean it should never be considered as part of the contractual terms especially if it has economic substance and is specific enough. In the staff's view, Guiding Principles B and C would consider whether dynamic terms should be considered as part of the contractual terms for classification purposes.

62. The staff do not recommend the Board further explore this approach because this approach would result in the classification outcome depending on the way the contractual term is referenced to future changes in the law rather than focusing on the nature of the rights and obligations. It is not always clear whether a term is static or dynamic in nature and even if it is clear, it is not certain whether that reference was intentional or unintentional. The staff note that based on our review of several contracts issued in the recent few years, most of the references to the relevant legal requirements appear to be made in a dynamic manner. The staff do not think this approach would meet the objective of consistent classification outcomes for economically similar instruments as described in paragraph 4 of this paper. It could also lead to structuring opportunities because entities could influence the classification outcome by the way they reference a contractual term to the law.

Disclosures

63. The staff note that the nature of any additional disclosures would be affected by the guiding principle(s) the Board decides on and the usefulness of the information to users of financial statements. Potential disclosures could include for example, disclosures of legal requirements that could affect the timing and amount of future cash flows of financial instruments an entity issued even if they do not affect their classification. Another example could be disclosure of legal requirements that limit, modify or prohibit the contractual obligations so that users of financial statements can understand their impact on a contract. The staff plan to analyse further whether additional disclosures would be beneficial and present this analysis to the Board at a future meeting.

64. In April 2021, the Board tentatively decided to require disclosures of particular terms and conditions for financial instruments that have contractual characteristics of both debt and equity instruments. For example, an entity would be required to disclose 'equity-like' contractual features in financial liabilities and 'liability-like' contractual features in equity instruments. The scope of this disclosure requirement was defined as 'contractual' terms and conditions. The Board's decisions on whether and how to consider the effects of laws in identifying contractual obligations and in classifying financial instruments would thus have consequences on the proposed disclosures of contractual terms and conditions. The staff would need to consider this impact further as it may affect the scope of the proposed disclosures.

Staff's preliminary views and next steps

65. If the Board agrees, the staff would like to further develop Guiding Principles A, B and C described in this paper and present the staff recommendation at a future Board meeting. As part of that process, the staff will analyse the usefulness of information resulting from the classification outcomes applying these principles. In our preliminary view, if a term does not create a right and obligation beyond what is required by law (applying Guiding Principle A), treating it as not part of the contractual terms (and not reflecting it in the classification outcome) does not result in a loss of information to investors because knowledgeable investors would

be aware of such general legal requirements that are not specific to an entity or to a financial instrument. In addition, if a legal requirement limits, modifies or prohibits specific contractual rights and obligations in a way that affects their enforceability, reflecting such effects in determining what are contractual rights and obligations by applying Guiding Principle B would help reflect the substance of the contractual arrangement in the classification. Furthermore, Guiding Principle C would limit the situations in which obligations that lack specificity are treated as contractual and are classified as a financial liability. The staff think it would help ensure that financial liabilities are recognised for obligations that are sufficiently specific.

66. In the staff's preliminary view, Guiding Principles A, B and C should therefore be applied as a package and in sequence. If an entity were to apply each guiding principle in isolation, it could reach a different classification outcome for the same financial instrument, as seen using the particular bail-in instrument example. This is the problem in practice today because entities interpret contractual and legal obligations in different ways. As Guiding principles A and B have a different underlying rationale and scope, and apply in different scenarios, we believe they both could work as a set of principles. In other words, both recommended Guiding principles should be considered to see if one of them is applicable. Guiding Principle C could supplement Guiding Principle B. In the staff's preliminary views, this approach will help achieve the overall objectives of eliminating diversity in practice, ensuring that economically similar instruments are classified in the same way and providing useful information to users of financial statements.

67. The staff are of the view that applying Guiding principles A, B and C would still be consistent with the principle of 'substance of the contractual arrangement' in paragraph 15 of IAS 32 and as discussed in Agenda Paper 5E. Guiding principle A looks at whether the contractual terms create rights or obligations that are distinct from or in addition to the legal rights and obligations. Guiding principle B looks at whether the legal requirements limit, clarify or explain existing contractual terms, regardless of whether those legal requirements are included in the contract explicitly. Guiding Principle C would help limit the situations where rights and obligations that lack specificity are considered as contractual.

68. The staff recognise there will be a question about whether a future change in the relevant law subsequent to initial recognition could require a reclassification of the financial instrument between financial liabilities and equity. Reclassification is one of the topics the Board decided to explore as part of this project and the staff will bring an analysis on reclassification relating to changes in law as part of the reclassification discussion. Our analysis in this paper follows the current approach in IAS 32 which focuses on classification of financial instruments at initial recognition.

69. The staff do not recommend the Board explore further Approaches X and Y for the reasons stated in paragraphs 54–62 of this paper.

Question for the Board

70. The staff would like to ask the following question.

Question for Board members
Do Board members have any comments or questions about the staff analysis, preliminary views and next steps discussed in Agenda Paper 5E and this paper? In particular, do Board members agree that the staff should further develop Guiding Principles A, B and C but not explore Approaches X and Y described in this paper?