IFRS Accounting

Staff paper

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Project	**Financial Instruments with Characteristics of Equity (FICE)**
Topic	**Presentation of financial liabilities**
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Purpose of this paper

1. The objective of this paper is to ask the International Accounting Standards Board (IASB) for a tentative decision related to the presentation of financial liabilities applying IAS 32 *Financial Instruments: Presentation*.

2. Over the years, stakeholders have raised concerns relating to a subset of financial liabilities which are subsequently measured at fair value through profit or loss (applying IFRS 9 *Financial Instruments)*. Stakeholders question the recognition of changes in the carrying amount of the financial liability in profit or loss when the financial liability contains a contractual obligation to pay the holder an amount based on the entity's performance or changes in the entity's net assets. They note that this results in counter-intuitive accounting in profit or loss because gains are recognised when an entity performs poorly and losses are recognised when an entity performs well. The 2018 Discussion Paper *Financial Instruments with Characteristics of Equity* (2018 DP) proposed presenting gains or losses on such instruments in other comprehensive income (OCI) instead of profit or loss (see paragraphs 15-19 of this paper).

3. One of the overall objectives of the FICE project is to improve the information an entity provides to users of financial statements about the financial instruments it has issued. This can be achieved through improving presentation and disclosures, instead of relying solely on classification of financial instruments to provide useful information about similarities and differences between claims. In this paper, the staff will consider the concerns raised by stakeholders and explore whether clarifications could potentially be made to IAS 32 or IFRS 7 *Financial Instruments: Disclosures* for the presentation of financial liabilities on the face of the financial statements.

4. This paper is structured as follows:

(a) Staff recommendation

(b) Questions for the IASB

(c) Background information

(i) Current requirements in IFRS Accounting Standards;

(ii) 2018 DP proposals and feedback;

(d) Staff analysis

Staff recommendation

5. The staff recommend that no changes are made to the presentation requirements in IAS 32 to specifically address financial liabilities containing contractual obligations to pay amounts based on the entity's performance or changes in the entity's net assets. The principles and requirements in IAS 1 *Presentation of Financial Statements*, including any decisions to be made as part of the Primary Financial Statements (PFS) project provide an adequate basis for entities to determine whether to present particular types of financial liabilities and their associated gains or losses separately in the financial statements.

6. However, the staff recommend entities with these types of financial liabilities measured at fair value through profit or loss be required to disclose the total gains or losses recognised in profit or loss in each reporting period that arise from remeasuring such financial liabilities. Therefore, entities would be required to disclose separately the amount of the net gains or losses on financial liabilities designated and/or mandatorily measured at fair value through profit or loss (applying IFRS 7) that relates to these types of financial liabilities. In our view, these disclosures, together with the proposed disclosures of key terms and conditions for financial liabilities with equity-like features, will address the information needs of users of financial statements.

Questions for the IASB

7. The staff would like to ask the following questions.

Questions for the IASB
1. Do IASB members agree with the staff recommendation that no changes are made to the presentation requirements in IAS 32 to specifically address

financial liabilities containing contractual obligations to pay amounts based on the entity's performance or changes in the entity's net assets?

2. Do IASB members agree with the staff recommendation that entities with these types of financial liabilities measured at fair value through profit or loss be required to disclose the total gains or losses recognised in profit or loss in each reporting period that arise from remeasuring such financial liabilities?

Background information

Current requirements in IFRS Accounting Standards

8. Applying IAS 32, financial instruments are classified as financial liabilities if they include an unavoidable obligation to pay cash or another financial asset or to settle the instrument in such a way that it would be a financial liability other than at liquidation. In some cases, the financial liability may have a feature that is 'typical' of one of the key cash flow characteristics of an equity instrument, namely payments for unspecified amounts. In this paper, we refer to such a feature as an 'equity-like feature'. For example, shares redeemable at fair value are classified as financial liabilities but have amounts payable based on the entity's share price at settlement date.

9. Paragraph 35 of IAS 32 requires interest, dividends, losses and gains relating to a financial instrument or a component that is a financial liability to be recognised as income or expense in profit or loss.

10. Paragraph 41 of IAS 32 explains that gains and losses related to changes in the carrying amount of a financial liability are recognised as income or expense in profit or loss even when they relate to an instrument that includes a right to the residual interest in the assets of the entity in exchange for cash or another financial asset. This paragraph also clarifies that applying IAS 1, the entity presents any gain or loss arising from remeasurement of such an instrument separately in the statement of comprehensive income when it is relevant in explaining the entity's performance.

11. Paragraph 20(a)(i) of IFRS 7 requires an entity to disclose either in the statement of comprehensive income or in the notes the net gains or net losses on financial liabilities measured at fair value through profit or loss, showing separately those on financial liabilities designated and those on financial liabilities that are mandatorily measured at fair value

through profit or loss in accordance with IFRS 9. For financial liabilities designated as at fair value through profit or loss, an entity shall show separately the amount of gain or loss recognised in OCI and the amount recognised in profit or loss.

12. Paragraph 55 of IAS 1 states that an entity shall present additional line items (including by disaggregating the line items listed in paragraph 54 of IAS 1), headings and subtotals in the statement of financial position when such presentation is relevant to an understanding of the entity's financial position. Paragraph 58 of IAS 1 explains that an entity makes the judgement about whether to present additional items separately on the basis of an assessment of the amounts, nature and timing of liabilities.

13. Paragraph 77 of IAS 1 states that an entity shall disclose, either in the statement of financial position or in the notes, further subclassifications of the line items presented, classified in a manner appropriate to the entity's operations.

14. Paragraph 85 of IAS 1 states that an entity shall present additional line items (including by disaggregating the line items listed in paragraph 82 of IAS 1), headings and subtotals in the statement(s) presenting profit or loss and other comprehensive income when such presentation is relevant to an understanding of the entity's financial performance.

2018 DP proposals and feedback

15. Although the IASB tentatively decided in September 2019 not to pursue the classification approach proposed in the 2018 DP, the staff considered the proposals for presentation of financial liabilities and whether the feedback thereon could support developing any further presentation proposals for financial liabilities.

16. The 2018 DP proposed separate presentation of the following financial liabilities:

    (a) financial liabilities that contain no obligation for an amount that is independent of the entity's available economic resources;

    (b) derivative financial assets and derivative financial liabilities that have net amounts that are unaffected by any independent variable; and

    (c) partly independent derivatives that meet specified criteria including that the derivative has a net amount that otherwise is unaffected by any other independent variable and the only independent variable is a currency other than the entity's functional currency.

17. In the IASB's preliminary view at the time, to facilitate assessment of balance-sheet solvency and returns associated with those instruments listed in the previous paragraph, an entity, should:

    (a) separately present their carrying amounts in the **statement of financial position**; and

    (b) present income and expenses arising from those instruments in **OCI** in the **statement of financial performance**, without subsequent reclassification (recycling).

18. The IASB's preliminary view was that using OCI would be a more effective way of applying the separate presentation requirements to income and expenses. For example, it would provide a clearer distinction between income and expenses that result from changes in the entity's available economic resources, and income and expenses presented in profit or loss, and it would alleviate the concern about counter-intuitive accounting.

19. There were mixed views from respondents. The staff reported the feedback to the IASB in Agenda Papers 5A and 5D of the July 2019 meeting. In summary:

    (a) some respondents (including many users of financial statements) broadly agreed with the proposals for separate presentation of financial liabilities in both the statement of financial position and statement of financial performance. They believed these liabilities are sufficiently different in nature and separate presentation would provide useful information and alleviate some of the concerns with the liability classification of these instruments.

    (b) other respondents (including a few users of financial statements) broadly disagreed with the proposals for separate presentation of financial liabilities in both the statement of financial position and statement of financial performance. They believed these instruments are likely to be immaterial or not widespread in practice; the requirements involve significant operational complexity and may clutter or unnecessarily overload the statement of financial position; and users of financial statements may find it difficult to understand the distinctions between different instruments, particularly partly independent derivatives. These respondents favoured additional disclosures of the nature and terms of these instruments in the notes to the financial statements.

    (c) some respondents explicitly agreed with the proposals for the statement of financial position but disagreed with the proposals for the statement of financial performance.

(d) some respondents agreed with the presentation of income and expenses arising from these financial instruments in OCI. They believed it promotes transparency to better assess the different nuances in the liability assessment, allows a better depiction in profit or loss of the return the entity produces to satisfy its claims, and avoids counter-intuitive accounting results.

(e) many respondents disagreed with the presentation of income and expenses in OCI as they did not support what they believe is a new type of liability that expands the use of OCI. Several concerns were raised including that presentation in OCI lacks conceptual basis, would not likely benefit users of financial statements because it can be used to hide volatility in earnings, and leads to an exception in presentation, replacing one rule with another rather than developing a principle-based outcome. Some respondents recommended either separate presentation in profit or loss or disclosures (for example, details of income and expenses arising from these financial instruments) in the notes as alternative approaches.

(f) a few users of financial statements said they did not have a strong view on where this income and expense should be presented as long as they were able to distinguish them from income and expenses from other types of financial liabilities.

(g) a few respondents specifically said they agreed with the proposal to not subsequently reclassify amounts presented in OCI to profit or loss. Some respondents commented that they would only support the separate presentation in OCI if there is a subsequent reclassification to profit or loss, with a few others questioning the non-recyclability of this OCI item from a conceptual basis.

Staff analysis

20. The IASB discussed financial liabilities with equity-like features in April 2021 when it tentatively decided on proposed disclosure requirements, and again in September 2022 when it tentatively decided on classification proposals for obligations to redeem own equity instruments including written put options on non-controlling interests (NCI puts) exercisable at fair value.

21. There is currently a growing number of different types of financial instruments that combine features of both financial liabilities and equity instruments and it is not feasible to develop

separate presentation requirements for each type of material financial instrument that could be issued.

22. The staff are aware that there are also concerns in practice about the impact of financial liability classification when an embedded derivative in a convertible bond does not meet the fixed-for-fixed condition[1] in IAS 32. For example, stakeholders question whether it is appropriate for conversion options in foreign currency denominated convertible bonds to be classified differently from derivatives that meet the foreign currency rights issue exception. Applying IAS 32, issued rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of *any currency* are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments.

23. In contrast foreign currency conversion options embedded in convertible bonds are classified as financial liabilities and remeasured through profit or loss. The 2018 DP referred to these as partly independent derivatives and proposed recognising all income and expenses separately in OCI using a criteria-based approach if the embedded derivatives were separated.

24. Similarly, there are concerns even in functional currency denominated convertible bonds when the conversion option does not meet the fixed-for-fixed condition. Stakeholders explain that the valuation of the conversion option results in counter-intuitive effects in profit or loss and recognising large valuation losses could lead to delisting even though it is not yet certain whether the host contract will be converted into equity.

25. The staff note that generally, income and expenses arising on financial liabilities are presented in profit or loss as set out in paragraph 35 of IAS 32. Paragraph 41 of IAS 32 is also clear that this principle applies even if gains or losses relate to an instrument that includes a right to the residual interest in the assets of the entity.

26. The staff also note that there was no consensus view from respondents regarding the 2018 DP proposals for separate presentation in the statement of financial position or statement of comprehensive income. In determining whether there is a need for the IASB to make changes to the presentation requirements in IAS 32 to specifically address financial liabilities containing contractual obligations to pay amounts based on the entity's performance or changes in the entity's net assets, the staff considered the:

[1] 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) relevant discussions and IASB tentative decisions as part of the PFS project;

(b) scope of the FICE project; and

(c) IASB's tentative decisions on disclosures as part of the FICE project.

PFS project

27. Some respondents to the 2018 DP suggested separate presentation of the income and expenses on financial liabilities containing contractual obligations to pay amounts based on the entity's performance or changes in the entity's net assets on the face of the statement of profit or loss instead of presenting the income and expenses in OCI.

28. Paragraph 85 of IAS 1 requires an entity to present additional line items (or disaggregate existing line items) in the statement(s) presenting profit or loss and other comprehensive income when such presentation is relevant to an understanding of the entity's financial performance.

29. The IASB is proposing requirements for presentation and disclosure in financial statements, with a focus on the statement of profit or loss as part of its Primary Financial Statements project. The IASB is currently redeliberating proposals in the Exposure Draft *General Presentation and Disclosures* which was published in December 2019. The staff considered the IASB's discussions and tentative decisions on the role of primary financial statements and the notes, principles for aggregation and disaggregation and specified line items in determining whether any clarifications are required for the presentation of issued financial instruments as part of the FICE project. See the staff analysis in paragraphs 39-49 of Agenda Paper 5A of this meeting.

30. In February 2022, the IASB also discussed required line items in the financing category as part of the PFS project and tentatively decided not to specify any required line items to be presented in the financing category in the statement of profit or loss.

31. We understand that the outcome of not specifying any required line items is that an entity will be required to either give a single line item for all amounts in the financing category[2], or use its judgement to present more than one line item, as necessary to provide an understandable

[2] An entity would be required to present a subtotal immediately before the financing category (profit or loss before financing and income tax) and is very likely to present a subtotal immediately after the financing category (profit or loss before tax).

overview of its income and expenses. Any disaggregation that results in material information not presented in the statement of profit or loss would be disclosed in the notes.

32. Considering the relevant IASB discussions and tentative decisions on the PFS project, the staff are of the view that entities should use their own judgement to present separately the income and expenses on financial liabilities containing contractual obligations to pay amounts based on the entity's performance or changes in the entity's net assets in the statement of profit or loss.

33. The staff also acknowledge that some entities are hesitant to present a separate line item if it will result in the provision of sensitive information—for example an NCI put exercisable at fair value. Stakeholders have told us that if the shares of the subsidiary are not quoted in an active market, the liability is measured using a model with many unobservable inputs and the separate presentation of this liability could prejudice negotiations of the final price when the NCI put is exercised.

34. Therefore, the staff are of the view that an entity should present additional line items or disaggregate existing line items when necessary to provide an understandable overview of the entity's income and expenses or assets and liabilities and equity. Considering the costs and benefits of requiring line items in the statement of profit or loss and statement of financial position (as discussed in paragraph 48 of Agenda Paper 5A of this meeting), the staff are of the view that there is no need for IAS 32 to require a separate line item in either the statement of profit or loss or statement of financial position for these types of financial liabilities. Entities therefore have to decide themselves whether they need to present additional line items or disaggregate existing line items in compliance with IAS 1.

Scope of the FICE project

35. The staff highlight that the objective of the FICE project is to address known practice issues by clarifying the underlying principles in IAS 32. Where there is no implicit or explicit principle in IAS 32 for a particular requirement, the IASB could fill this gap by developing a principle and accompanying rationale, but the intention is not to develop new principles that will result in fundamental changes to the current requirements in IAS 32.

36. The staff are of the view that given the scope and objective of this project, it would be too broad and too big a change to introduce the presentation of gains or losses on some types of financial liabilities in OCI, regardless of whether recycling is required or not. Such a change would not only be a departure from the requirements in IAS 32 but also from IFRS 9 which

generally requires gains or losses on financial liabilities to be recognised in profit or loss other than fair value changes attributable to own credit risk for financial liabilities designated as at fair value through profit or loss. In addition, recognising changes in these financial liabilities in profit or loss is also consistent with paragraphs 4.68 and 4.69 of the *Conceptual Framework for Financial Reporting* which define income and expenses with reference to decreases and increases in liabilities.

37. Furthermore, a tentative decision not to recognise income and expenses in OCI would be consistent with the IASB's discussion in September 2022 on accounting for financial instruments containing obligations to redeem an entity's own equity instruments including written NCI puts. The IASB discussed the concern about counter-intuitive accounting outcomes in profit or loss for some instruments such as written NCI puts exercisable at fair value. However, they acknowledged that recognising those changes in OCI would represent a fundamental change to the requirements in IAS 32 which is outside the scope of the FICE project.

IASB's tentative decisions on FICE disclosures

38. The IASB considered in Agenda paper 5A for the April 2021 meeting, potential refinements to the disclosure proposals explored in the 2018 DP for information about terms and conditions of financial instruments an entity issues. If finalised, these disclosure proposals would be incorporated into IFRS 7.

39. As discussed in paragraph 8 of this paper, financial liabilities containing contractual obligations to pay amounts based on the entity's performance or changes in the entity's net assets would be an example of financial liabilities with equity-like features.

40. The IASB tentatively decided that, for financial instruments with characteristics of both financial liabilities and equity instruments (including compound instruments and excluding stand-alone derivatives), an entity would be required to disclose in the **notes** to the financial statements, information about:

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

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

(c) debt-like and equity-like features that determine the classification of such financial instruments as financial liabilities, equity instruments or compound financial instruments.

41. The disclosures would also apply to embedded derivatives on own equity. The most common form of derivatives on own equity is conversion options in convertible bonds. Where the conversion option is an embedded derivative liability, it would be in the scope of the terms and conditions disclosures. This is because the equity-like feature in a non-derivative financial liability often arises from the embedded derivative. Where the conversion option is a derivative that meets the fixed-for-fixed condition, the disclosure proposed for compound instruments in paragraph 40(c) of this paper would apply.

42. The staff are of the view that the proposed disclosures about terms and conditions tentatively agreed to by the IASB would provide users of financial statements with more information about financial liabilities containing contractual obligations to pay amounts based on the entity's performance or changes in the entity's net assets. Users of financial statements would have more transparency about the existence and features of these types of financial liabilities and would be able to better analyse the effect of these instruments on the entity's financial position and financial performance.

43. Based on feedback from users of financial statements and other stakeholders in prior consultations, the IASB had identified that users of financial statements undertake two broad assessments of financial position and financial performance—assessments of funding liquidity and cash flows and assessments of balance-sheet solvency and returns. In making assessments of balance-sheet solvency and returns, users of financial statements consider, amongst others, the extent to which the entity has claims that respond to future changes in the entity's available economic resources. This assessment will show how resilient the entity's financial position is to reductions in the value of its economic resources. This assessment also identifies which claims participate in future reductions and appreciation of its available economic resources.

44. In addition, based on feedback from stakeholders about the importance of distinguishing income and expenses on these types of financial liabilities, we think that users of financial statements could also benefit from disclosure of the *total amount* of gains or losses recognised in profit or loss that arise from remeasuring these types of financial liabilities in the reporting period. This is consistent with feedback on the 2018 DP, where many respondents suggested that disclosures are a preferred alternative to separate presentation requirements

for these types of financial liabilities ie an alternative to deferring the gains or losses and presenting them in OCI.

45. Applying paragraph 5.7.1 of IFRS 9, a gain or loss on a financial liability that is measured at fair value through profit or loss (and is not part of a hedging relationship) is recognised in profit or loss (with the exception of changes in the credit risk of a financial liability designated at fair value through profit or loss to which paragraph 5.7.7 of IFRS 9 applies). The staff are of the view that the fair value of financial liabilities containing contractual obligations to pay amounts based on the entity's performance or changes in the entity's net assets would largely be affected by changes in the entity's performance or changes in the entity's net assets. These types of financial liabilities would generally be measured at fair value through profit or loss because the financial liability would likely be one of the following:

    (a) a stand-alone derivative financial liability;

    (b) an embedded derivative that is not closely related to host financial liability and is separated; or

    (c) an entire (hybrid) contract that is designated at fair value through profit or loss because the contract contains one or more embedded derivatives that would otherwise be required to be separated.

46. Applying paragraph 20(a)(i) of IFRS 7, the net gain or net loss on financial liabilities *designated* as at fair value through profit or loss would be presented or disclosed separately from the net gain or net loss on financial liabilities *mandatorily measured* at fair value through profit or loss (derivatives and financial liabilities held for trading). In addition, for financial liabilities *designated* as at fair value through profit or loss, the amount of gain or loss recognised in OCI is required to be shown separately from the amount recognised in profit or loss. However, some of the amounts recognised in profit or loss applying this requirement in IFRS 7 may relate to financial liabilities containing contractual obligations to pay amounts based on the entity's performance or changes in the entity's net assets. The current requirements in IFRS Accounting Standards do not provide users of financial statements with information about the extent to which an entity's profit or loss was affected by changes in the entity's performance or changes in the entity's net assets.

47. Requiring such additional disclosure of the *total amount* of gains or losses recognised in profit or loss that arise from remeasuring these types of financial liabilities in the reporting period would thus provide users of financial statements with information to understand the profit or

loss effect of changes that are related to the entity's performance or changes in the entity's net assets and distinguish them from income and expenses arising from other types of financial liabilities. Together with the proposed disclosures on key terms and conditions, the staff are of the view that these disclosures would be sufficient to meet the needs of users of financial statements.

48. If the IASB tentatively agrees to require such additional disclosure, the staff will further consider how best to develop these disclosure requirements in a future meeting when we circle back on disclosures. At that future meeting, the staff also plan to consider more comprehensively whether any further disclosures are required as a result of the potential clarifications made to IAS 32 in the FICE project.