IFRS® Foundation

Financial Instruments with Characteristics of Equity

Accounting Standards Advisory Forum meeting

ASAF Agenda Paper **4**
July 2022

Purpose of this session and contents

- Provide an update on the FICE project
- Obtain ASAF members' views on some of the IASB's tentative decisions to date (slides 10 and 15 set out questions for ASAF members)

Timeline and next steps

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Q4 2019	Q2 2020	H1 2021	Q4 2021	Q1 2022		TBD
Project plan agreed	Fixed-for-fixed condition	'Perpetual instruments' and Disclosures	Contingent settlement provisions and the effects of laws	Shareholder discretion and Reclassifications	. . .	Exposure Draft

Remaining topics:

- **Classification of obligations to redeem own equity instruments** (eg NCI puts)
- **Presentation** (including obligations that arise only on liquidation)
- **Disclosure** (any further requirements)
- **Other** (eg transition)

Financial instruments with contingent settlement provisions

Requirements in paragraph 25 of IAS 32

Financial liability classification	Equity classification
A financial instrument may require the entity to deliver cash or another financial asset, or otherwise to settle it in such a way that it would be a financial liability, in the event of the **occurrence or non-occurrence** of **uncertain future events**…that are **beyond the control** of **both** the issuer and the holder of the instrument…it is a **financial liability** of the issuer **unless**:	(a) the part of the contingent settlement provision that could require settlement in cash or another financial asset (or otherwise in such a way that it would be a financial liability is **not genuine;** (b) the issuer can be required to settle the obligation in cash or another financial asset (or otherwise settle it in such a way that it would be a financial liability) only in the event of **liquidation** of the issuer; or (c) the instrument has all the features and meets the conditions in paragraphs 16A and 16B

Practice questions

Example	Contingent convertible instrument
Key Features	• No maturity date • Convertible into a variable number of own shares if the issuer breaches the Common Equity Tier 1 Capital ratio • Contingent event is outside the control of both the issuer and holder and could potentially occur immediately • Issued at par and convertible into a variable number of shares to the value of the fixed par amount • Dividends are discretionary
Liability component	Contractual obligation to settle the instrument in a variable number of issuer's own shares upon a contingent event
Equity component	Discretionary dividends

Order of applying requirements in IAS 32	Is there **a required order** in which an issuer applies the requirements in IAS 32 when a compound financial instrument contains contingent settlement features?
Impact of probability on measurement	**What is 'the fair value of a similar liability'** when the contingency is part of the liability component?
Discretionary payments	How are **subsequent discretionary distributions** recognised if all of the issuance proceeds are allocated to the liability component at initial recognition?

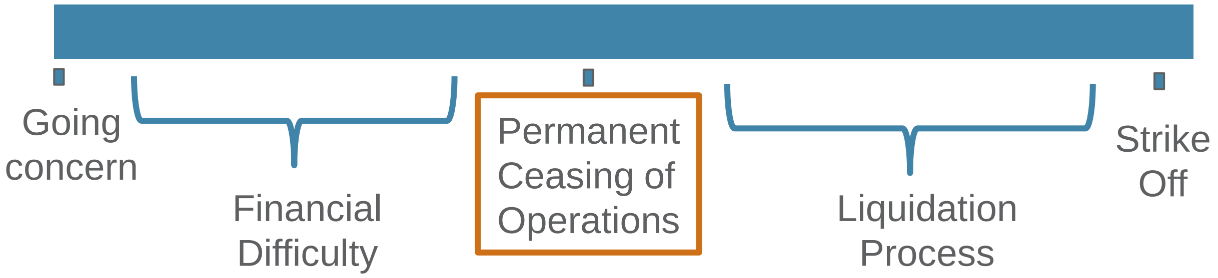
IASB tentative decisions

Order of applying requirements in IAS 32	Financial instruments with contingent settlement provisions may be compound instruments
Impact of probability on measurement	The liability component of a compound financial instrument with contingent settlement provisions, which could require immediate settlement if a contingent event occurs, is measured at the full amount of the conditional obligation
Discretionary payments	Payments at the discretion of the issuer are recognised in equity, even if all the proceeds are initially allocated to the liability component of a compound financial instrument

Other proposed amendments

Liquidation

Stages of a business



IASB tentative decision

‘Liquidation’ refers to when an entity is in the process of permanently ceasing operations

Non-genuine

Extremely rare

Highly abnormal

Very unlikely

IASB tentative decision

‘Not genuine’ assessment is not made by considering only the probability of the contingent event occurring

Questions for ASAF members

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In your view, would the IASB's tentative decisions on financial instruments with contingent settlement provisions

a) resolve practice issues?

b) have any unintended consequences?

Effects of laws on the contractual terms

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Background

Underlying principle	Classification of financial instruments as financial liabilities or equity instruments is based solely on contractual terms. Paragraph 15 of IAS 32 requires entities to classify financial instruments 'in accordance with the substance of the contractual arrangement'.	
Practice Questions	Whether a legal requirement that is reproduced or referred to in the contract is necessarily part of the contractual terms.	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.
Objectives in developing principles	Reduce diversity in practice by providing principles that would enable entities to determine whether the applicable laws are part of the contractual terms.	Improve the comparability of the financial statements by requiring consistent classification for economically similar financial instruments.

Effects of laws on the contractual terms

Explicitly Stated Contractual Terms

Generally applicable legal requirements	**Example:**	General regulator powers in bail-in instrument
Terms more specific than those required by law	**Example:**	Specific loss absorption feature of bail-in instrument

Terms not found in the contract

Laws that prevent enforceability of terms	**Example:**	Law prohibits redemption feature
Laws create obligations	**Example:**	Law mandates 10% of profits to be distributed as dividends

Consider in classification

Do not consider in classification

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IASB tentative decision

Classify financial instruments as financial liabilities or equity by considering:

Terms explicitly stated in the contract that give rise to rights and obligations that are in addition to, or more specific than, those established by applicable law

Applicable laws that prevent the enforceability of a contractual right or a contractual obligation

Questions for ASAF members

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In your view, would the IASB's tentative decisions on the effects of laws on the contractual terms
a) resolve practice issues?
b) have any unintended consequences?

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