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STAFF PAPER

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Project	Financial Instruments with Characteristics of Equity (FICE)	
Paper topic	Reclassification—proposed clarifications (part 1)	
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Purpose of this paper

1. The purpose of this paper and Agenda Paper 5B of this meeting is to ask the International Accounting Standards Board (IASB) for tentative decisions on proposed clarifications related to the reclassification of financial instruments between financial liabilities and equity instruments applying IAS 32 *Financial Instruments: Presentation*.

2. At its March 2022 meeting (Agenda Paper 5), the IASB discussed whether an entity is required or permitted to reassess the classification of a financial instrument as a financial liability or equity after initial recognition. Diversity in practice exists when there are changes in the substance of the contractual terms without a modification to the contract such that reassessment would result in a different classification outcome from that initially assessed. The IASB also discussed potential next steps to address this practice issue and directed the staff to develop potential reclassification principles.

3. In this meeting, the staff present further analysis taking into account that feedback and focus on changes in the substance of contractual terms without a modification to the contract because this was the area with the most accounting diversity and that raised

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the most practice questions from stakeholders. Two types of such changes were identified:

(a) changes in circumstances for example, from a change in functional currency or the parent entity losing control over a subsidiary; or

(b) changes due to an existing contractual term becoming or ceasing to be effective with the passage of time for example, expiry of an option embedded in the contract or variable settlement terms becoming fixed after a specified date.

4. This paper begins the staff's analysis and is structured as follows:

(a) Background;

(b) Types of changes

(c) IFRS 9 reclassification and reassessment requirements; and

(d) Advantages and disadvantages of reclassification

5. Agenda Paper 5B of this meeting continues the staff's analysis focusing on potential approaches the IASB could consider.

Staff analysis

Background

6. IAS 32 explicitly requires an issuer of a financial instrument to classify the instrument, or its component parts, on initial recognition and has no general requirements for reclassifying financial liabilities and equity instruments after initial recognition when the instrument's contractual terms are unchanged.

7. As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A-16B or paragraphs 16C-16D of IAS 32. These paragraphs apply to puttable instruments and instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation (hereafter referred to as 'puttable instruments and obligations arising on liquidation'). Paragraphs 16E–16F of IAS 32 contain specific requirements for reclassification when the instrument meets/ceases to meet the conditions and/or has/ceases to have all the features set out in paragraphs 16A–16B or 16C–16D of IAS 32, as relevant.

8. In March 2022, the IASB discussed the difference between derecognition and reclassification. IFRS 9 sets out the requirements for the derecognition of financial liabilities. In that paper, the staff analysed how the recognition of a new financial instrument following the derecognition of a financial liability is different from a 'reclassification'.[1] Based on the analysis, the staff concluded that reclassification:

   (a) refers to a change in the classification of an existing financial instrument when there has been no derecognition.

   (b) would not involve the recognition of a new financial instrument.

   (c) may be a way to reflect that the nature of the obligation has substantially changed when the requirements for derecognition and recognition are not met. Reclassification may therefore be appropriate when a financial instrument continues to exist but there has been a change in the substance of its contractual terms without a modification to the contract.

Types of changes

9. Before setting out alternative approaches the IASB could consider, the staff further explored the different types of changes in the substance of contractual terms that could occur without a modification to the contract (hereafter referred to as 'changes in the substance of the contractual terms').

10. The staff note that the proposed clarifications will not affect any existing requirements in IAS 32 where the word 'reclassification' may be used in a broader sense or inferred. Examples include reclassifications related to entering into a new contract to purchase own shares and reversal of that reclassification upon expiry of a put option on own shares (paragraph 23 of IAS 32) or a change in classification when a party exercises a call option in an existing contract (paragraph AG25 of IAS 32).

11. The types of changes (described in paragraph 3 of this paper) can be distinguished based on whether they are endogenous or exogenous to the contract. Some types of changes are expected from initial recognition of the financial instrument because they result from terms and features that are described in the contract even if they are

[1] Paragraphs 34-43 of Agenda Paper 5 of the March 2022 IASB meeting

triggered by an external or contingent event (ie endogenous). Other types of changes are not stipulated in the contract because they are not expected and cannot be foreseen on initial recognition of the financial instrument ie they result from uncertain future events outside the contract (ie exogenous).

Changes due to the passage of time

12. Changes in the substance of the contractual terms as a result of the passage of time are known or anticipated at inception of the contract when the parties to the contract agreed to its terms.

13. In March and September 2021, the Committee discussed the application of IAS 32 in relation to the reclassification of warrants. Specifically, the request described a warrant that provides the holder with the right to buy a fixed number of equity instruments of the issuer of the warrant for an exercise price that will be fixed at a future date. At initial recognition, because of the variability in the exercise price, the issuer, in applying paragraph 16 of IAS 32, classifies these instruments as financial liabilities. However, the substance of the contractual terms changes when existing contractual terms become effective with the passage of time. The exercise price becomes fixed at the end of a specified period, from which point the warrant would meet the 'fixed-for-fixed' condition if it was assessed at that date. In other words, if exercised, the warrant will be settled by the exchange of a fixed number of shares for a fixed amount of functional currency cash.

14. A similar practice issue arises in convertible bonds where the number of shares that will be delivered if the conversion option is exercised is determined only at a future date when the conversion price becomes fixed. In both these examples, the entity will know the exact number of shares required on conversion/exercise and the conversion/exercise price because both would be determined prior to the conversion option or warrant being exercised. This is different from a conversion option that will be settled in a variable number of shares to be determined on the exercise date. The nature of the obligation changes from an obligation to settle in a variable number of shares to an obligation to settle in a fixed number of shares.

15. Other examples of changes in the substance of the contractual terms as a result of the passage of time include:

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

(b) a put option in an instrument that allows the holder to put the instrument back to the entity for a fixed amount of cash during a specified period of the instrument's life. The put option expires unexercised at the end of the specified period.

(c) an instrument classified on the basis of a contingency occurring within a specified period of time, but the contingency does not occur during that period.

16. Contingent consideration that will be settled in own equity instruments (described in paragraph 15(a) of this paper) is in the scope of IAS 32 and a similar question about reclassification arises as for the warrants and convertible bonds discussed in paragraph 13 of this paper.

17. Both examples of financial instruments described in paragraphs 15(b)–15(c) of this paper contain a contractual obligation that meets the definition of a financial liability (eg an obligation to deliver cash if a put option is exercised by the holder or if an uncertain future event occurs before the end of Year 2) that would expire after a specified period of time. Once that specified point in time is passed, the issuer would have the unconditional right to avoid settlement in cash ie the substance of the contractual terms changes when the existing contractual terms cease to be effective.

Change in an entity's functional currency

18. Changes in the substance of the contractual terms can arise from a change in an entity's functional currency which is an example of a change in circumstances arising outside of the contract that was not foreseen when the contract was entered into.

19. The staff acknowledge that changes in an entity's functional currency may not be frequent and IAS 21 *The Effects of Changes in Foreign Exchange Rates* contains a high hurdle to change the functional currency of an entity. Paragraph 36 of IAS 21 explains that once the functional currency is determined, it can be changed only if there is a change to the underlying transactions, events and conditions that are relevant to the entity. For example, a change in the currency that mainly influences the sales prices of goods and services may lead to a change in an entity's functional currency.

20. An example of where a change in an entity's functional currency changes the substance of contractual terms without a modification to the contract, is a warrant that provides the holder with the right to buy a fixed number of the issuer's own equity instruments in exchange for a fixed amount of cash denominated in the issuer's functional currency. At initial recognition, the issuer classifies the warrant as an equity instrument because it meets the fixed-for-fixed condition. However, if after initial recognition, the issuer's functional currency changes, the amount of cash to be exchanged is no longer 'fixed' in the issuer's functional currency. The inverse of this example could also arise—ie at initial recognition, the warrant is classified as a financial liability because the amount of cash to be exchanged is denominated in a currency other than the issuer's functional currency but, subsequently, the issuer's functional currency changes such that the amount of cash to be exchanged is considered 'fixed'.

21. When a change in functional currency occurs, the financial instrument starts or ceases to meet the fixed-for-fixed condition to be classified as equity. Although the financial instrument continues to exist as set out in the contractual terms, the nature of the obligation has changed from a foreign currency obligation to a functional currency obligation (or vice versa).

Changes to the entity's organisational structure

22. Changes in the substance of the contractual terms can arise from a change to the entity's organisational structure which is another example of a change in circumstances arising outside of the contract that was not foreseen when the contract was entered into.

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

equity' for a fixed amount of cash. Although the derivative continues to exist as set out in the contractual terms, the nature of the obligation to deliver shares in settlement changes from the group's 'own equity' to 'shares of an entity outside the group' (or vice versa).

24. Paragraph 8 of IFRS 10 *Consolidated Financial Statements* explains that reassessment of whether an investor controls an investee would be required if facts and circumstances indicate that there are changes to one or more of the three elements of control.

Linked instruments

25. Changes in the substance of the contractual terms can arise from the settlement of linked instruments which affect the payments to be made on the financial instrument in question. These changes could also result from a change in circumstances outside of the contract. Consider for example, an issued instrument (the 'base' instrument) that is non-redeemable with discretionary coupons and only requires coupon payments to be made when contractual mandatory interest payments are made on another instrument issued by the entity (the 'linked' instrument). Without any modification to the contract, the substance of the contractual terms of the base instrument changes when the linked instrument is settled and redeemed. The base instrument continues to exist but the entity is no longer obliged to make coupon payments in the future.

Changes in laws affecting enforceability of a contract

26. In December 2021, the IASB discussed when an entity would be required to consider the effect of applicable laws in classifying a financial instrument as a financial liability or equity. In doing so, an entity would consider the laws in effect on initial recognition of the financial instrument ie it would not be required to predict possible future changes in the relevant law.

27. The IASB tentatively decided to propose amendments to IAS 32 to require an entity to classify a financial instrument as a financial liability or equity by considering:

    (a) 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; and

(b) applicable laws that prevent the enforceability of a contractual right or a contractual obligation.

28. We note that in some cases, a change in law may require the issuer to modify the contractual terms to comply with the new legal requirements. In other cases however, the contractual terms do not need modification to comply with the new legal requirements either because:

(a) they had already included more specific or additional requirements compared to what is in the law; or

(b) a legal requirement in the contract automatically changes to reflect changes in the statutory or regulatory requirements. In practice this is commonly referred to as a 'dynamic term[2]' or 'dynamic reference' because it is updated as laws are changed unilaterally by the government.

29. In the staff's view, the question of reclassification due to a change in the relevant law only arises in the case of applicable laws that prevent the enforceability of a contractual right or obligation (described in paragraph 27(b) of this paper). This is because in the case of terms that give rise to rights and obligations that are in addition to, or more specific than those established by applicable law (described in paragraph 27(a) of this paper), the staff expect the instrument would retain its classification if the law changes without a modification to the contract. This is because either there is no change in the substance of the contractual terms or no change in the manner of settlement.

30. For example, consider bail-in instruments that requires conversion to a variable number of shares when the minimum capital ratio is breached. The law could change the minimum capital ratio from 5% to 7% such that the trigger event could occur earlier. However, in this example, it is only the timing of the trigger event that is affected and not the classification of the financial instrument because it will still be settled in a variable number of shares upon the trigger event.

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[2] As discussed in the IASB September 2021 meeting, the IASB did not further explore a classification approach that depends on the way the contractual term is referenced to future changes in the law. Instead, it focused on the nature of the rights and obligations so both static and dynamic terms could be considered in the classification approach tentatively agreed on by the IASB in December 2021.

31. In contrast, if there is a change in the law that prevents the enforceability of a contractual right or obligation, the question of reclassification arises if the substance of the contractual terms has changed without a modification of the contract.

32. Based on the IASB's tentative decision in December 2021, applicable laws that prevent the enforceability of a contractual right or a contractual obligation are considered in the classification decision. This means those applicable laws are *treated* as if they were part of the contractual terms for classification purposes. Consistent with the IASB's tentative decision, when there is a *change in law* that changes the enforceability of contractual terms without a modification to the contract, it is therefore *treated* as a modification of the contract so would not be in the scope of any proposed clarifications developed in this project.

IFRS 9 reclassification and reassessment requirements

33. The staff first considered the rationale for reclassifying financial instruments or reassessing the separation of embedded derivatives in IFRS 9 to see if similar principles could apply for potential reclassifications between financial liabilities and equity instruments. We will discuss these requirements further when we discuss alternative approaches the IASB could consider in Agenda Paper 5B of this meeting.

Reclassification requirements for financial assets and financial liabilities

34. Applying IFRS 9 to financial assets, an entity is required to assess the contractual cash flow characteristics of a financial asset only at initial recognition of the financial assets. Reassessment is not permitted for changes such as the expiry of a contractual term. Paragraph BC 4.117 of IFRS 9 states:

> The IASB considered arguments that reclassification should also be permitted or required when contractual cash flow characteristics of a financial asset vary (or may vary) over that asset's life based on its original contractual terms. However, the IASB noted that, unlike a change in business model, the contractual terms of a financial asset are known at initial recognition. An entity classifies the financial asset at initial recognition on the basis of the contractual terms over the life of the instrument. Consequently, the IASB decided that reclassification on the basis of a financial asset's contractual cash flows should not be permitted.

35. IFRS 9 requires financial assets to be reclassified when, and only when, an entity changes its business model for managing financial assets. Paragraph B4.4.1 of IFRS 9 explains that such changes are expected to be very infrequent, must be significant to the entity's operations and demonstrable to external parties. IFRS 9 also specifically prohibits reclassification of any financial liability.

36. Paragraphs BC4.113-114 of IFRS 9 states:

> However, almost all respondents (including most users) argued that prohibiting reclassification is inconsistent with a classification approach based on how an entity manages its financial assets. They noted that in an approach based on an entity's business model for managing financial assets, reclassifications would […] ensure that financial statements faithfully represent how those financial assets are managed at the reporting date. In particular, most users stated that, conceptually, reclassifications should not be prohibited when the classification no longer reflects how the instruments would be classified if the items were newly acquired. If reclassification were prohibited, the reported information would not reflect the amounts, timing and uncertainty of future cash flows.
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> The IASB was persuaded by these arguments and decided that reclassification should not be prohibited. The IASB noted that prohibiting reclassification decreases comparability for like instruments managed in the same way.

Reassessment requirements for separating embedded derivatives

37. Paragraph B4.3.11 of IFRS 9 clarifies that the assessment of whether or not an embedded derivative is required to be separated from its host contract is undertaken when the entity first becomes party to the contract. It prohibits subsequent reassessment unless there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract. This requirement was incorporated into IFRS 9 from IFRIC 9 *Reassessment of Embedded Derivatives.*

38. In reaching that conclusion, the Committee had discussed the question of reassessment when the terms of the embedded derivative do not change but market conditions

change and the market was the principal factor in determining whether the host contract and embedded derivative are closely related. Instances when this might arise are those in paragraph B4.3.8(d) of IFRS 9 relating to embedded foreign currency derivatives.

39. Paragraph BCZ4.102-BCZ4.103 of IFRS 9 states (**emphasis added**):

> When the IFRIC considered this issue in 2006, it noted that the rationale for the requirement to separate particular embedded derivatives is that an entity should not be able to circumvent the recognition and measurement requirements for derivatives merely by embedding a derivative in a non-derivative financial instrument or other contract […]. **Changes in external circumstances are not ways to circumvent the requirements**. The IFRIC therefore concluded that reassessment was not appropriate for such changes.
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> […] The IFRIC noted that **requiring entities to reassess embedded derivatives in all hybrid instruments could be onerous because frequent monitoring would be required**. Market conditions and other factors affecting embedded derivatives would have to be monitored continuously to ensure timely identification of a change in circumstances and amendment of the accounting treatment accordingly. For example, if the functional currency of the counterparty changes during the reporting period so that the contract is no longer denominated in a currency of one of the parties to the contract, then a reassessment of the hybrid instrument would be required at the date of change to ensure the correct accounting treatment in future.

40. The Committee had also considered the implications of requiring subsequent reassessment and the questions of recognition and measurement that would arise if a previously separated embedded derivative was no longer required to be separated. These included:

(a) when to remove the derivative from the balance sheet or amortise it;

(b) whether to recognise a gain or loss in profit or loss when removing the derivative from the balance sheet even though there had been no transaction and no change in the value of the total contract or its components; or

(c) combining the derivative with the host which would alter both the carrying amount of the host and its effective interest rate even though there had been no change in the economics of the whole contract.

The Committee noted that, under its view that subsequent reassessment is appropriate only when there has been a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required by the contract, the above issues do not arise.

Advantages and disadvantages of reclassification

41. Before setting out the alternative approaches the IASB could consider, the staff list below some advantages and disadvantages of reclassification based on our research and feedback from stakeholders.

42. The following are arguments in favour of reclassification:

    (a) faithful representation of the financial instrument and the substance of the contractual arrangement at the reporting date. This provides useful information to users of financial statements about the amounts, timing and uncertainty of future cash flows. Paragraph 2.12 of the *Conceptual Framework for Financial Reporting* explains that 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. Paragraph 2.13 goes on to explain that the IASB's objective is to maximise, to the extent possible, the three characteristics of faithful representation, ie to be complete, neutral and free from error.

    (b) reflects how the instrument would be classified if it was newly issued so entities that issued financial instruments with similar features as the reclassified financial instrument would provide comparable information to users of financial statements.

43. The following are arguments against reclassification:

(c) increases costs and complexity for preparers of financial statements because reassessment would be required at each reporting date to assess whether a reclassification is needed. Entities would have to provide evidence that they have assessed all their contracts to determine whether there is a change in the substance of the contractual terms, especially for changes due to the passage of time. In addition, there would be changes in the measurement and subsequent accounting for financial instruments reclassified from equity to financial liabilities.

(d) may not provide users of financial statements with useful information if reclassification requirements are not applied consistently, result in frequent reclassifications or create possible structuring opportunities to achieve a particular classification outcome.

44. Agenda Paper 5B of this meeting includes the remainder of the staff's analysis which sets out alternative approaches, our preferred approach and a question for the IASB.