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STAFF PAPER

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Project	**Financial Instruments with Characteristics of Equity (FICE)**	
Paper topic	Reclassification—introduction	
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Purpose of this paper

1. The objective of this paper is to begin the International Accounting Standards Board (IASB)'s discussion on reclassifications. At its October 2019 meeting (Agenda Paper 5), the IASB discussed the project plan for the FICE project, including the practice issues that it could address as part of the project. One of the topics discussed was reclassification between financial liability and equity instruments.

2. In this paper, the staff only explore what clarifications could potentially be made to IAS 32 *Financial Instruments: Presentation*, without asking the IASB to make any decisions. Based on the IASB feedback provided at this meeting, the staff will develop a proposal for the clarified principles and bring back a further analysis at a future IASB meeting.

Introduction

3. 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 on reclassification between financial liabilities and equity instruments.

4. Questions have arisen in practice regarding the classification of financial liabilities and equity instruments after initial recognition in the case of:

   (a) modifications of the contractual terms of a financial instrument (including a compound instrument); and

   (b) a change in the substance of the contractual terms without a modification of the contract. These changes are discussed in paragraphs 44–61 of this paper and include:

      (i) a change in circumstances for example, a change in functional currency or losing control over a subsidiary; or

      (ii) a change due to the passage of time for example, expiry of an option or variable settlement terms becoming fixed.

5. The staff understand that it is common in many jurisdictions for entities to modify the contractual terms of an instrument including in such a way that the classification outcome would be different from that initially assessed. The purpose of this paper is not to discuss what constitutes modifications and derecognition as this would be outside the scope of this project. In addition, the substance of the contractual terms could change without modification to the contract. The feedback on the Discussion Paper *Financial Instruments with Characteristics of Equity* (2018) (2018 DP) (see paragraphs 24–26 of this paper) highlighted that many respondents believe it is unclear whether IAS 32 requires an entity to reassess the classification of a financial instrument after initial recognition especially when its contract is not modified, and if so, when.

6. Feedback from informal outreach and the published guidance of the accounting firms implies that there may be diverse accounting practice especially when the substance of the contractual terms changes without a modification of the contract.

In addition, the IFRS Interpretations Committee (the Committee) previously discussed two issues related to this topic:

(a) In 2006, the Committee considered a situation in which an amendment to the contractual terms of an equity instrument resulted in the instrument being classified as a financial liability of the issuer (see paragraphs 30–31 of this paper).

(b) In 2021, the Committee discussed whether the issuer reclassifies a warrant as an equity instrument following the fixing of the warrant's exercise price after initial recognition as specified in the contract (see paragraphs 32–33 of this paper).

7. Consistent with the project objective as discussed by the IASB in October 2019, the staff will explore whether the issue could be addressed without fundamentally changing the requirements in IAS 32.

8. This paper does not consider reclassifications between IFRS Accounting Standards (Accounting Standards) dealing with financial instruments and other Accounting Standards for example, if an instrument is originally in the scope of IFRS 2 *Share-based Payment*, whether it can subsequently be in the scope of IAS 32. Doing so would be outside the scope of this project.

9. This paper is structured as follows:

(a) current requirements in IAS 32;

(b) requirements in related financial instrument Accounting Standards;

(c) background;

(d) staff analysis; and

(e) question for the IASB.

Current requirements in IAS 32

10. IAS 32 contains no general requirements for reclassifying financial liabilities and equity instruments after initial recognition when the instrument's contractual terms are unchanged.

11. Applying paragraph 15 of IAS 32, an issuer of a financial instrument classifies the instrument, or its component parts, on initial recognition in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument.

12. Paragraphs 16E–16F of IAS 32 contain specific requirements for the reclassification of 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'). Reclassification is required 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. Paragraph 96B of IAS 32 explains that the puttable instruments exception was a limited scope exception and should not be applied by analogy. The staff researched the background to these reclassification requirements to try to understand whether the same rationale can be applied to the issues in this paper. See paragraphs 21–22 of this paper.

13. There are other references to reclassifications or wording in IAS 32 that relates to a revised classification. The staff note that these requirements apply in specific circumstances that are neither a modification of the contract nor a change in the substance of the contractual terms of the type we will be discussing in this paper (see paragraph 4 of this paper). Consider the following examples (*emphasis added*) where either a new contract is entered into or a party to the contract exercises an option in an existing contract:

    (a) paragraph 23 of IAS 32 discusses the accounting for a contract containing an obligation for an entity to purchase its own equity instruments for cash or another financial asset and requires:

        (i) a financial liability to be recognised initially at the present value of the redemption amount, *reclassified* from equity; and

        (ii) *reclassification* of the financial liability to equity if the contract expires without delivery.

    (b) paragraph AG25 of IAS 32 explains that an issuer option to redeem preference shares for cash does not satisfy the definition of a financial liability. However, an *obligation may arise* when the issuer of the shares exercises its option, usually by formally notifying the shareholders of an intention to redeem the shares.

(c) paragraph 30 and AG32 of IAS 32 addresses compound instruments and specifies that:

(i) classification of the liability and equity components of a convertible instrument is *not revised* as a result of a change in the likelihood that a conversion option will be exercised;

(ii) the entity's contractual obligation to make future payments *remains outstanding until it is extinguished* through conversion, maturity of the instrument or some other transaction; and

(iii) on conversion of a convertible instrument at maturity, the entity *derecognises the liability component and recognises it as equity*.

14. The staff understand that in practice the term reclassification is sometimes used synonymous to derecognition. However, we do not agree with this and we analyse the difference between derecognition and reclassification later in paragraphs 34–41 of this paper.

Requirements in related financial instrument Accounting Standards

15. Other financial instrument Accounting Standards contain some requirements that may be relevant to the discussion in this paper. The staff will consider whether the requirements in these Accounting Standards could be used in developing any principles on reclassification between financial liabilities and equity instruments. For the avoidance of doubt, the staff are not proposing any changes to these other Accounting Standards.

16. IFRS 9 requires financial assets to be reclassified between measurement categories when, and only when, an entity changes its business model for managing financial assets. Paragraph 4.4.3 of IFRS 9 lists some changes in

circumstances that are not reclassifications. IFRS 9 also specifically prohibits reclassification of any financial liability between measurement categories.

17. 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.

18. IFRS 9 also addresses derecognition of financial liabilities. Paragraph 3.3.1 of IFRS 9 states that an entity shall remove a financial liability (or a part of a financial liability) when, and only when, it is extinguished (i.e. when the obligation specified in the contract is discharged or cancelled or expires). Paragraph 3.3.2 of IFRS 9 explains that a substantial modification of the terms of an existing financial liability shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

19. When an instrument is derecognised, new instruments may be issued as consideration. Paragraph 3.3.3 of IFRS 9 refers to the consideration paid including liabilities assumed and IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments* says the issue of an entity's own equity instruments to a creditor is consideration paid in accordance with paragraph 3.3.3 of IFRS 9. IFRIC 19 addresses the accounting when the terms of a financial liability ae renegotiated and result in the entity issuing equity instruments to a creditor to extinguish all or part of the financial liability.

20. IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* requires particular types of puttable and redeemable instruments such as members' shares in co-operative entities and similar instruments to be classified as equity. The appendix to IFRIC 2 contains an example of an entity that amends its governing charter to increase the permitted level of cumulative redemptions. This amendment affects the prohibition against redemption of members' shares and results in the transfer of amounts between equity and financial liabilities.

Background

Brief history of the puttable instruments' reclassification requirements

21. In discussions leading to the issuance of the Exposure Draft *Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation* published in 2006, the IASB discussed that because the puttable instruments have to meet strict criteria to qualify for equity classification, it is conceivable that reclassification may occur due to a change in an entity's capital structure or the instrument's conditions. For example, the classification of puttable instruments could be changed by the issuance or redemption of another class of financial instrument that is in the most subordinated class but does not have identical features. The IASB also discussed that disclosure about reclassification would result in better transparency and increased understandability when changes in classification occur because the classification affects measurement.

22. In finalising the amendments, the IASB decided to add the reclassification requirements in paragraphs 16E–16F of IAS 32 and paragraph 96B of IAS 32 which says the exception cannot be applied by analogy. In addition, the IASB added disclosure requirements about reclassification of puttable instruments and obligations arising on liquidation in paragraph 80A of IAS 1 *Presentation of Financial Statements*. Disclosures should include the amount reclassified between financial liabilities and equity, and the timing and reason for that reclassification.

2008 FICE DP

23. In the predecessor to the current FICE project, the Board had issued the Discussion Paper *Financial Instruments with Characteristics of Equity* in February 2008 ('2008 DP'). It contained a section on reclassification because of the specific approaches proposed in that DP. It acknowledged that IAS 32 does not require classification to be reassessed unless the terms and conditions of the instrument have changed, except for some puttable instruments and obligations arising on liquidation. It further observed that IAS 32 does not provide guidance on how reclassifications from equity to liability or vice versa should be recorded, except for reclassification of some puttable instruments and obligations arising on liquidation. Under two of the approaches explored in the 2008 DP, reassessment

of classification would be required at each reporting date and no gain or loss would be recognised in profit or loss on reclassification even if reclassification results in remeasurement of the instrument. Instead, an entity would recognise in equity any difference in value upon reclassification.

Recent feedback from stakeholders

Proposals in the 2018 DP

24. There were no specific proposals for reclassification of financial instruments in the 2018 DP. However, it asked respondents whether they agreed with the 2018 DP's description of the challenges and their causes and whether they think there are other factors contributing to the challenges. Many respondents observed that IAS 32 is silent on re-classifications, except for puttable instruments and obligations arising upon liquidation. They noted that this has resulted in different interpretations and diversity in practice whether an entity is required to reassess the classification of a financial instrument after initial recognition especially when its contract is not modified. The classification outcome may be different from an initially assessed outcome if there are changes in the substance of the contractual terms subsequently including an expiry of a feature of the financial instrument that had prevented equity classification, for example a written put option for cash, or other factors such as a change in the entity's functional currency.

25. A few respondents questioned whether there should be a continuous reassessment each reporting period or after the instrument is initially recognised when the contract is not modified.

26. Despite the Committee's agenda decision in 2006 (see paragraphs 30-31 of this paper), a few respondents to the 2018 DP still said it is unclear whether the modification of a contract requires reclassification and how such modifications are accounted for. A respondent however said they recognise that when the characteristics of an instrument are modified, this creates a new instrument and thus, an assessment of its appropriate classification is required.

Informal outreach with large accounting firms

27. The published guidance of large accounting firms appears to be consistent in requiring reclassification when the terms of a financial instrument are modified in such a way that an instrument that was an equity instrument at initial recognition would be classified as a financial liability if issued at the date of modification, or vice versa.

28. However, on the topic of reclassifications without a modification of the contract, the published guidance of large accounting firms confirms that there are differing views in practice. Some require reclassification, while others allow an accounting policy choice to reclassify. The examples provided of circumstances that require or permit reclassification also differs across firms.

29. The staff performed informal outreach with some of the large accounting firms to understand their published views and the rationale for the differing views in practice. This was useful especially because the topic of reclassification was not discussed in the 2018 DP. These discussions highlighted that practice has developed over time and some of the reasons why the large accounting firms require or permit reclassification:

    (a) published guidance on reclassifications is long-standing and established—it can be traced back to 2009 or earlier~~,~~ and has largely not been revised since.

    (b) there is a perceived tension between the requirements in IFRS 9 and IAS 32—in their view, applying the IFRS 9 derecognition requirements would lead to derecognition for example, of a financial liability if the definition of a financial liability is no longer met. In contrast, applying the IAS 32 classification requirements, no reclassification is permitted on the basis that a strict reading of IAS 32 only allows classification at inception.

    (c) in their view, reclassification allows the accounting to be based on the contractual substance of the arrangement— there should be no difference between reclassifying due to an amendment of contractual terms and due to a change in the 'effective terms' eg an existing contractual term expires.

(d) in their view, reclassification allows the statement of financial position to reflect circumstances at the reporting date—classification should consider the users of the financial statements and whether it provides useful information to users of the financial statements to, for example, classify an instrument as a financial liability if it no longer meets the definition of a financial liability.

IFRS Interpretations Committee discussions

2006 agenda decision—Changes in the Contractual Terms of an Existing Equity Instrument (modification of contractual terms)

30. In 2006 the Committee was asked to consider a situation in which an amendment to the contractual terms of an equity instrument resulted in the instrument being classified as a financial liability of the issuer. A respondent to the Committee's tentative agenda decision commented that there is no explicit guidance in the literature, IAS 32 does not address the circumstances in which a modification of the terms of an equity instrument constitutes derecognition of that instrument, and therefore there are equally valid alternative interpretations which can be applied. However, the Committee believed that the requirements of IFRS Accounting Standards, taken as a whole, were sufficiently clear and that the issue was not expected to have widespread relevance in practice.

31. It noted that when the contractual terms were changed, a financial liability was initially recognised, and, furthermore, that a financial liability on initial recognition is measured at its fair value in accordance with paragraph 43 of IAS 39 (carried forward in paragraph 5.1.1 of IFRS 9). The Committee observed that the change in the terms of the instrument gave rise to derecognition of the original equity instrument and that paragraph 33 of IAS 32 states that no gain or loss shall be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments. The Committee, therefore, believed that, when the terms were changed, the difference between the carrying amount of the equity instrument and the fair value of the newly recognised financial liability should be recognised in equity.

2021 agenda decision—Accounting for Warrants that are Classified as Financial Liabilities on Initial Recognition (change in substance of contractual terms)

32. In 2021 the Committee received a request about 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. This is because for a derivative financial instrument to be classified as equity, it must be settled by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments ('fixed-for-fixed condition'). The request asked whether the issuer reclassifies the warrant as an equity instrument following the fixing of the warrant's exercise price after initial recognition as specified in the contract, given that the fixed-for-fixed condition would at that stage be met.

33. The Committee observed that IAS 32 contains no general requirements for reclassifying financial liabilities and equity instruments after initial recognition when the instrument's contractual terms are unchanged. The Committee acknowledged that similar questions about reclassification arise in other circumstances. The Committee concluded that the matter described in the request is, in isolation, too narrow for the IASB or the Committee to address in a cost-effective manner. Instead, the IASB should consider the matter as part of its broader discussions on the FICE project. For these reasons, the Committee decided not to add a standard-setting project to the work plan.

Staff analysis

Derecognition vs reclassification

34. The staff understand that in practice, derecognition may sometimes be confused with reclassification (ie a change in classification) and the terms 'derecognition' and 'reclassification' are sometimes used synonymously. The confusion arises

especially if a financial liability is removed from the statement of financial position and replaced with equity (or vice versa) as this could occur in both a derecognition and a reclassification scenario. In addition, entities sometimes account for a derecognition and a reclassification in the same way.

35. In this section we explore the differences between these terms. We are not yet considering whether reclassification should be required or prohibited but rather what a reclassification entails and how it differs from a derecognition.

36. IFRS 9 sets out the requirements for the derecognition of financial liabilities. A financial liability is only derecognised when the derecognition requirements are met. Paragraph 3.3.1 of IFRS 9 states that an entity shall remove a financial liability from the statement of financial position when, and only when, it is extinguished (ie when the obligation specified in the contract is discharged or cancelled or expires). Paragraph 3.3.2 of IFRS 9 explains that a substantial modification of the terms of an existing financial liability shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

37. When a financial liability is extinguished, new instruments may be issued as consideration. Paragraph 3.3.3 of IFRS 9 refers to the consideration paid including liabilities assumed and IFRIC 19 says the issue of an entity's own equity instruments to a creditor is consideration paid in accordance with paragraph 3.3.3 of IFRS 9.

38. Paragraph 3.1.1 of IFRS 9 addresses the initial recognition of financial assets and financial liabilities: 'an entity shall recognise a financial asset or financial liability in its statement of financial position when, and only when, the entity becomes party to the contractual provisions of the instrument'.

39. Although IAS 32 does not include a similar requirement for the timing of recognising equity instruments, in applying paragraphs 15–16 of IAS 32, the same timing would apply to equity instruments. When the entity becomes a party to the contractual provisions of the issued instrument, it will either classify the financial instrument as a financial liability or equity instrument.

40. In contrast, it can be argued that reclassification could arise when a financial instrument continues to exist albeit in a different form. A reclassification of an

existing financial instrument would not involve the recognition of a new financial instrument. If there is a change in the substance of the contractual terms without a modification to the contract, the staff think no new financial liability or equity instrument should be recognised. Therefore, reclassification 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.

41. In summary, the staff are of the view that the recognition of a new financial instrument following the derecognition of a financial liability is not a ‘reclassification’. The relevant requirements in IAS 32 and IFRS 9 are applied to determine the classification and measurement of the new financial instrument. In contrast, reclassification refers to a change in the classification of a financial instrument when there has been no derecognition. This could arise from a change in the entity’s circumstances or when the current contractual terms become or cease to be effective.

42. The staff do not intend to analyse modifications to the contractual terms of a financial instrument in this project given the existing requirements such as those in IFRS 9 for financial liabilities, IFRIC 19, and the Committee’s agenda decision on the subject (see paragraphs 30-31 of this paper) which is applied as part of IAS 32. In addition, the staff are of the view that no special principles are required for modifications related to compound instruments compared to modifications to instruments that are wholly financial liabilities or wholly equity instruments.

43. The IASB can instead focus on considering changes in the substance of the contractual terms without a modification to the contract, which is the area to which most practice questions relate.

A change in the substance of the contractual terms without a modification to the contract

44. Some stakeholders refer to these changes as changes to the effective terms without a modification to the contract. They commonly arise when relevant contractual terms of an instrument, which are contemplated in the contract, become effective or cease to be effective with the passage of time. However, they also arise from a change in circumstances of the entity outside of the contract, ie change in functional currency or change in control and as a result, if the instruments were

classified after that, they would be classified differently. They share a similarity to the cases when puttable instruments or obligations arising only on liquidation are required to be reclassified because they also do not arise from a modification to the contract but rather when the substance of the contractual terms changes.

Practice questions

45. Based on the staff's research, discussions with stakeholders and feedback on the 2018 FICE DP, questions have arisen about whether IAS 32 permits or requires reclassification after initial recognition when the substance of the contractual terms changes without a modification to the contract. Some of the most frequent examples were (the list is not exhaustive):

(a) changes as a result of the passage of time, for example:

(i) 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.

(ii) 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.

(iii) a put option issued on an instrument that allows the holder to put the instrument back to the entity for a fixed amount of cash during only the first three years of the instrument's life. The put option expires unexercised at the end of the three years.

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

(b) change in an entity's functional currency—for example, 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. After initial recognition of the warrant, the issuer’s functional currency changes and, as a result, 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’.

(c) changes to the entity’s ownership structure—for example, 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. After initial recognition of the derivative, the parent loses control of that subsidiary and, as a result, 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 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.

(d) settlement of linked instruments affecting the payments to be made on another instrument—for example, an issued instrument (the ‘base’ instrument) that only requires interest payments to be made when contractually 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 have changed because it no longer contains a contractual obligation to make payments after the linked instrument is settled.

46. In December 2021, the IASB discussed when an entity would be required to consider the effect of applicable laws in classifying financial instruments as financial liabilities or equity instruments. 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. The staff recognised that there might 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. For example, a change in applicable laws that prevent the enforceability of a contractual right or a contractual obligation. A change in laws is similar in nature to a change in circumstances because it arises from an event other than the parties to the contract agreeing to amend the contractual terms.

Potential next steps

47. To address the practice questions that relate to changes in the substance of the contractual terms without a modification to the contract, there are two views the IASB could consider —either *require* reclassification or *prohibit* reclassification unless IAS 32 specifically requires it. The staff do not recommend allowing an accounting policy choice as this would result in continued diversity in practice which leads to a lack of comparability between entities that have issued similar financial instruments. The staff are of the view that reduction or elimination of accounting diversity will improve the usefulness of information provided to users of the financial statements.

48. The staff describe each potential view below and plan to bring a more detailed analysis of each view to a future IASB meeting. As described in paragraphs 28–29 of this paper, this is a long standing question and practices of reclassification have developed over time, we therefore expect prohibiting reclassification between equity and financial liabilities to result in a bigger change in practice than requiring reclassification.

49. Once the IASB decides on a view, it could add a principle addressing reclassification to IAS 32. If the view is to require reclassification, the IASB could supplement the principle with illustrative examples of reclassifications when the contractual terms are not modified to facilitate the consistent application of the principle.

Approach A – prohibit reclassification

50. This approach would be based on an interpretation that paragraph 15 of IAS 32, which requires classification on initial recognition of a financial instrument, was intended to generally prohibit subsequent reclassification. A further clarification could be added to that paragraph that financial instruments are not reclassified between financial liabilities and equity instruments unless IAS 32 specifically requires it. For example, the requirements in paragraphs 16E–16F of IAS 32 for puttable instruments and obligations arising on liquidation require reclassification.

51. The staff note that applying IFRS 9 to financial assets, an entity is required to assess their contractual cash flow characteristics at initial recognition of the assets. Reassessment is not permitted for changes such as the expiry of a contractual term. The staff plan to consider whether a similar principle should apply to reclassification between financial liabilities and equity.

52. If the IASB decides to prohibit reclassification for changes in the substance of the contractual terms without a modification to the contract, it could consider requiring entities to still disclose information about the effects of such changes on the nature of the obligation. The staff think it would be appropriate to include such disclosures in the proposed disclosures on the key terms and conditions of financial instruments with characteristics of both debt and equity discussed by the IASB in April 2021. The IASB's tentative decision included disclosures of 'equity-like' features in financial liabilities and vice-versa. The staff will analyse further whether such additional disclosures would provide useful information to users of financial statements.

Approach B – require reclassification

53. Under this approach, reclassification would be required to reflect the substance of the contractual terms of the financial instrument at the reporting date. Although there has been no modification to the contract, the substance of the contractual terms that are effective for the remaining life of the financial instrument have effectively changed. Under this approach, the change in the substance of the contractual terms would require reclassification.

54. The staff plan to consider whether a similar requirement for reclassification as that in paragraphs 16E–16F could apply to changes in the substance of contractual

terms without a modification of the contract other than for puttable instruments and obligations arising on liquidation. This analysis will also consider whether reclassification should be required only for some changes in the substance of the contractual terms such as a change in circumstances that was not contemplated in the contract but prohibited for others such as the passage of time changes that was specified in the contract. The staff plan to consider the usefulness of the information provided by reclassification in those scenarios to the users of financial statements. In addition, the staff plan to analyse further the issues described in paragraphs 55–61 of this paper.

Timing of reclassification

55. Some stakeholders have questioned the timing of reclassification. The staff will consider further when reclassification, if required, should be assessed and when it should be recognised. A reclassification could be recognised at the date the substance of the contractual terms have changed which would coincide with a particular event or change in circumstance eg expiry of an option, change in functional currency, issue or redemption of a linked instrument. Alternatively, similar to the IFRS 9 requirements on reclassifying financial assets, a reclassification could be recognised the first day of the first reporting period following the change in the substance of the contractual terms that results in the reclassification.

Measurement on reclassification

56. The staff note that in practice when an equity instrument is reclassified to a financial liability, there appears to be no diversity in how any gains or losses are recognised because it is seen as similar to a cancellation of an equity instrument. Paragraph 33 of IAS 32 states that no gain or loss shall be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments. A financial liability is required by IFRS 9 to be recognised at fair value on initial recognition (adjusted for transaction costs if not measured at fair value through profit or loss). Consequently, any difference between the carrying amount of the equity instrument and the fair value of the financial liability would be recognised in equity.

57. This accounting treatment was confirmed by the Committee in the context of a modification to the contractual terms of an equity instrument that resulted in the instrument being classified as a financial liability. This accounting is also consistent with paragraph 16F(a) of IAS 32 on reclassification of puttable instruments and obligations arising on liquidation from equity to liability, which requires any difference between the carrying value of equity and fair value of the financial liability to be recognised consistently with the original classification ie in equity. If the IASB decides to require reclassification for changes in the substance of the contractual terms without a modification to the contract, it may be worth clarifying that any difference between the carrying amount of the equity instrument and the fair value of the financial liability would be recognised in equity on reclassification from equity to financial liability.

58. Diversity in practice appears to exist for a reclassification of a financial instrument from financial liability to equity when the substance of the contractual terms changes without a modification of the contract. If there was a modification of the contractual terms resulting in derecognition, a gain or loss on derecognition of the financial liability would have been recognised in profit or loss consistent with the requirements in IFRS 9 and the conclusion in IFRIC 19. The question arises in practice as to whether an entity should analogise to:

(a) the conclusion in IFRIC 19 which applies when there is a renegotiation of the terms of the financial liability—measure an equity instrument at its fair value (or if this cannot be reliably measured, the fair value of the financial liability extinguished) and recognise any difference between this amount and the carrying amount of the financial liability in profit or loss;

(b) the requirement in paragraph 16F(b) of IAS 32 on puttable instruments and obligations arising on liquidation—measure an equity instrument at the carrying value of the financial liability at the date of reclassification and recognise no gain or loss (despite the wording in paragraph 96B of IAS 32 which could be seen to prohibit application by analogy); or

(c) the requirement in paragraph AG 32 of IAS 32 on the conversion for compound instruments at maturity—the entity derecognises the liability component and recognises it as equity and no gain or loss is recognised on conversion at maturity.

59. If the IASB decides to require reclassification for changes in the substance of contractual terms without a modification of the contract, it may be worth clarifying whether it is appropriate to recognise a gain or loss in profit or loss on reclassification from financial liability to equity.

60. The staff notes that if the financial liability is measured at fair value through profit or loss, for example in the case of a derivative on own equity that does not meet the fixed-for-fixed condition, then reclassification to equity at the carrying amount or the fair value of the financial liability would not result in any gain or loss being recognised.

Disclosure of reclassification

61. If the IASB decides to require reclassification for changes in the substance of the contractual terms without a modification of the contract, it could consider expanding the current disclosure requirements in IAS 1 for reclassification specifically between financial liabilities and equity. They currently only address reclassification of puttable instruments and obligations arising on liquidation. Disclosures of reclassifications would help users of financial statements better understand the change in classification and the impact on measurement, if any.

Question for the IASB

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

Question for the IASB
Do IASB members have any comments or questions?