IFRS® Foundation

Financial Instruments with Characteristics of Equity

Islamic Finance Consultative Group Meeting

Agenda Paper 1

May 2022

Topics for today

- Project overview
- Derivatives on own equity (fixed-for-fixed condition)
- Perpetual instruments
- Disclosures
- Financial instruments with contingent settlement provisions and Shareholder discretion
- Effects of laws on contractual terms
- Reclassification

Project overview

Objective and timeline

- **Improve information** provided in financial statements about financial instruments issued
- **Address known practice issues** applying IAS 32 *Financial Instruments: Presentation* without fundamentally rewriting IAS 32 by clarifying underlying principles

Q2 2020	Q1 2021	Q2 2021	Q4 2021	Q1 2022		TBD
Fixed-for-fixed condition	'Perpetual instruments'	Disclosures	Contingent settlement provisions and the effects of laws	Shareholder discretion and Reclassifications	...	Exposure Draft
Slides 6–9	Slides 11–12	Slides 14-17	Slides 19-22, 25	Slide 23,27		

Derivatives on own equity (fixed-for-fixed condition)

Fixed-for-fixed condition

- Two principles are proposed to meet ‘fixed-for-fixed’ condition in paragraph 16(b)(ii) of IAS 32
- Particular adjustments would not preclude equity classification if they meet the adjustment principle

Foundation principle

The number of functional currency units to be exchanged with each share is fixed

Adjustment principle

Preservation adjustments preserve relative economic interests of future shareholders to an equal or a lesser extent than those of existing shareholders

Passage-of-time adjustments:

- are pre-determined
- vary only with passage of time
- fix the amount per share in terms of present value

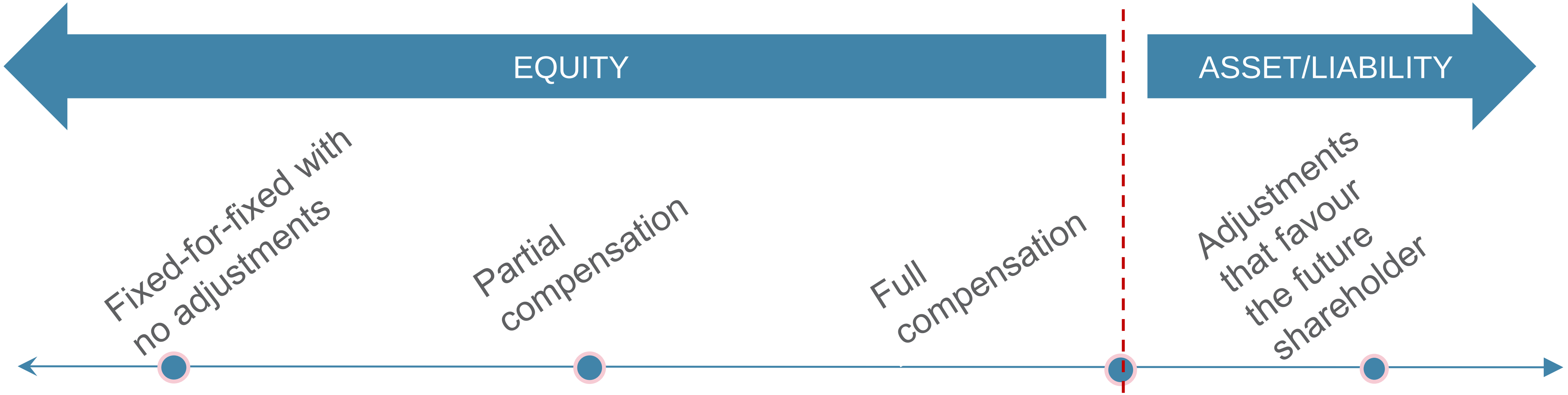
Foundation principle

Classify as equity if the number of functional currency units to be exchanged with each underlying equity instrument is fixed

Examples	Classification
Fixed-for-fixed derivative A written call option that gives the holder a right to buy 100 of the company's own shares for CU100 in cash in five years	**Equity** The issuer knows how much cash it will receive for each share, ie CU1 per share
A variable number of shares to a fixed value A written call option that gives the holder a right to buy as many of the company's own shares as are worth CU100 in exchange for CU95 in cash	**Financial liability** The issuer does not know how much cash it will receive for each share

Allowable preservation adjustments

Classify as equity if preservation adjustments require the company to preserve the relative economic interests of future shareholders to an equal or a lesser extent than those of the existing shareholders



Eg CU100 for 100 shares

Eg CU100 for 100 shares with strike price adjusted for annual dividends but not for special dividends

Eg CU100 for 100 shares but strike price adjusted for annual dividends and special dividends

Eg ‘down round’ provision

Allowable passage-of-time adjustments

Classify as equity if passage-of-time adjustments:

- **are pre-determined and vary only with the passage of time; and**
- **fix the number of functional currency units per underlying equity instrument in terms of a present value (PV)**

Examples	Classification
Company A issues an option that can be exercised for predetermined amounts at predetermined dates: • 10 shares for CU100 at end of Year 1 • 10 shares for CU150 at end of Year 2 • 10 shares for CU500 at end of Year 3	**Likely to be a financial liability** Not likely to be an allowable adjustment because the contract does not fix the amount per share in terms of PV (PV at inception of CU150 in Year 2 is unlikely to be the same as PV at inception of CU500 in Year 3 applying the same discount rate)

Perpetual instruments

Features of both debt and equity

Like debt?

- ‘In good times, it behaves like debt.’ Unless in financial difficulties, the issuer will pay the stated coupon at each coupon date. Payment typically expected to occur.
- The coupon is set as a % of the principal amount, like debt. Coupon rate on some instruments will reset to a higher rate after the first call date, incentivising redemption.
- In many jurisdictions, entities often choose and are expected by investors to repay the principal amount at the first call date. The instrument is often priced based on such expectation.
- Invested in by fixed income investors. Usually ranks ahead of ‘shareholders’.

Like equity?

- ‘In bad times, it behaves like equity.’ If the entity faces financial difficulties, these instruments act as a buffer as the entity can defer cash outflows (ie the coupons and principal).
- Typically subordinated to all other issued instruments (except ordinary shares) in terms of liquidation priority.
- In addition, many capital instruments issued by banks are converted into ordinary shares or written down if the bank’s capital position deteriorates. Such loss absorption capacity may be considered an equity-like feature.

Research and outreach

Market size

Regulatory Capital	Corporate Hybrids
Restricted Tier 1 (RT1) Additional Tier 1 (AT1)	Utilities Telecommunication Oil and Gas Automobile
Total: > $250 billion[1]	Total: > EUR 150 billion[2]

Regulatory Environment

A change in accounting classification is not expected to affect the regulatory capital classification

Feedback from equity investors

Most equity analysts preferred financial liability classification

If equity classification is retained, separate presentation and additional disclosures in the notes would provide useful information

IASB Tentative Decision

- No change in classification
- Develop presentation and disclosure requirements

1. This refers to the global AT1 market as at April 2020. Source: S&P Global, Europe's AT1 Market Faces The COVID-19 Test, April 2020
2. This refers to the European market as of May 2019. Source: Credit Suisse, European Corporate Hybrids 2019 Annual Update

Disclosures

Disclosures—
Key terms and conditions

Objective

Help investors better understand the nature, amount, timing and uncertainty of cash flows arising from issued financial instruments

Scope

- Financial instruments with characteristics of both debt and equity
- Includes compound instruments
- Excludes standalone derivatives

Requirements

Highlight:

- cash flow characteristics that are not ‘typical’ of the instrument's classification (eg fixed or determinable amounts of cash flows at fixed dates are ‘typical’ cash flows of debt instruments but not equity instruments)
- key features that determine classification

Disclosures—
Maximum dilution of ordinary shares

Objective

- Provide information about dilution that could arise from any potential increase in number of issued ordinary shares
- Not to replace Diluted EPS calculation

Scope

- All instruments and transactions settled by delivering ordinary shares
- Includes IFRS 2 instruments and transactions (entities can leverage existing IFRS 2 disclosures)

Requirements

- Underlying principle is for an entity to assume:
  - maximum possible increase in number of shares for instruments that could be settled by delivering own shares
  - minimum reduction in number of shares for instruments to repurchase own shares
- Disclosures include key terms and conditions relevant to understanding the likelihood of maximum dilution and the possibility for unknown dilution

Disclosures—Priority on liquidation: claims against the entity

Objective

Provide information about nature and priority of claims against the entity that arise from financial instruments

Scope

All financial liabilities and equity instruments within the scope of IAS 32

Requirements

Categorise financial instruments by differences in nature and priority, distinguishing between:

- secured and unsecured
- contractually subordinated and unsubordinated
- issued/owed by parent and issued/owed by subsidiaries

Disclosures—Priority on liquidation: contractual terms about priority

Objective

Provide information about the risks and returns of financial instruments on liquidation of the entity

Scope

- Financial instruments with characteristics of both debt and equity
- Includes compound instruments
- Excludes standalone derivatives

Requirements

Disclose terms and conditions about priority of financial instruments on liquidation, including:

- terms that indicate priority
- terms that could lead to changes in priority
- details of intragroup arrangements such as guarantees

Financial instruments with contingent settlement provisions and Shareholder discretion

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 classification	Does the **probability of the contingent event** occurring affect classification?
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

Shareholder discretion

Paragraph 19 of IAS 32

If an entity does not have an **unconditional right to avoid** delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a financial liability […]

Question considered

When a contractual obligation to deliver cash (or to settle it in such a way that it would be a financial liability) is at the discretion of the issuer's shareholders, **is a decision of shareholders treated as a decision of the entity?**

The IASB tentatively decided to explore a factors-based approach to help entities apply judgement. Examples of potential factors to consider:

Type of decision	Whether the decisions would be routine in nature and made as a part of the entity's corporate governance process
Who would initiate the decision	Whether the decision would be initiated by management and subject to shareholders' approval or initiated by shareholders
Would different shareholders benefit differently from the decision	Whether different classes of shareholders would benefit differently or whether shareholders are also holders of the instruments being assessed

Effects of laws on the contractual terms

Effects of laws on the contractual terms

IASB tentative decision

Classify financial instruments as financial liabilities or equity by considering:

1. 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
2. Applicable laws that prevent the enforceability of a contractual right or a contractual obligation

Applicable Laws	Contractual Terms	
Legal requirements not stated in the contract that should be included in classification Eg law prohibits redemption feature	Legal requirements explicitly stated in the contract that should be included in classification and other contractual terms Eg specific loss absorption feature of bail-in instrument	Legal requirements explicitly stated in the contract that should be excluded from classification Eg general regulator powers in bail-in instrument

Reclassifications

Reclassifications between financial liabilities and equity instruments

IAS 32 requirements

Paragraph 15 explicitly requires an issuer of a financial instrument to classify the instrument, or its component parts, on initial recognition

No general reclassification requirements

Paragraphs 16E-16F contain specific requirements for reclassifying puttable instruments and obligations arising on liquidation

Diversity in practice

Is reclassification required or permitted?

A change in the substance of the contractual terms **without modification** of the contract includes:

i) **change in circumstances** eg a change in functional currency or losing control over a subsidiary; or

ii) **changes due to** an existing contractual term becoming or ceasing to be effective with the **passage of time** for example, expiry of an option or variable settlement terms becoming fixed

IFRS Interpretations Committee Agenda Decision

2021: 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

The Committee concluded that the matter is, in isolation, too narrow to address in a cost-effective manner and should be considered as part of FICE project

IASB next steps

The IASB will consider proposals for potential reclassification principles

If reclassification is required, related issues arise on timing, measurement and disclosures

Questions?

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