IFRS® Accounting

Staff paper

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Project	**Financial Instruments with Characteristics of Equity (FICE)**
Topic	**Transition**
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This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board (IASB). This paper does not represent the views of the IASB or any individual IASB member. Any comments in the paper do not purport to set out what would be an acceptable or unacceptable application of IFRS® Accounting Standards. The IASB's technical decisions are made in public and are reported in the IASB® *Update*.

Purpose and structure

1. The purpose of this paper is to ask the International Accounting Standards Board (IASB) for tentative decisions related to transition when an entity applies the proposed amendments to IAS 32 *Financial Instruments: Presentation,* IFRS 7 *Financial Instruments: Disclosures* and IAS 1 *Presentation of Financial Statements* as part of the FICE project.

2. A summary of the IASB's tentative decisions on classification, presentation and disclosure topics to date is provided in Agenda Paper 5A of this meeting.

3. This paper is structured as follows:

   (a) Staff recommendations;

   (b) Question for the IASB;

   (c) Staff analysis

      (i) Current requirements in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors;*

      (ii) Entities already applying IFRS Accounting Standards;

      (iii) First-time adopters; and

(iv) Effective date.

Staff recommendations

4. The staff recommend:

(a) the proposed amendments are required to be applied fully retrospectively with comparatives restated;

(b) for entities already applying IFRS Accounting Standards, the IASB:

(i) provide transition relief related to the proposed classification requirements. When it is impracticable (as defined in IAS 8) to apply the effective interest method retrospectively, the fair value at the beginning of the earliest comparative period presented would be treated as the amortised cost of the financial liability at that date. When the liability component of a compound financial instrument with a contingent settlement provision is no longer outstanding at the date of initial application, an entity is not required to separate the liability and equity components.

(ii) require disclosure of the nature and amount of any changes in classification resulting from initial application.

(iii) provide transition relief from the quantitative disclosures in paragraph 28(f) of IAS 8.

(iv) provide no transition relief from the requirements in IAS 34 *Interim Financial Reporting* for interim financial statements issued within the annual period in which an entity first applies the amendments.

(c) for first-time adopters, the IASB provide transition relief related to the proposed classification requirements. Where it is impracticable (as defined in IAS 8) to determine the fair value of a financial liability prior to the date of transition, an entity would use the fair value at the date of transition.

Question for the IASB

Questions for the IASB
1. Does the IASB agree with the staff's recommendations as set out in paragraph 4 of this paper?

Staff analysis

Current requirements in IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors

5. Paragraph 19 of IAS 8 requires an entity to account for a change in accounting policy from the initial application of an IFRS Accounting Standard in accordance with the specific transitional provisions, if any, in that IFRS Accounting Standard. If there are no specific transitional provisions applying to that change, or an entity changes an accounting policy voluntarily, it shall apply the change retrospectively (subject to paragraph 23 of IAS 8).

6. Paragraph 22 of IAS 8 explains that retrospective application (subject to paragraph 23 of IAS 8) requires the entity to adjust the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented as if the new accounting policy had always been applied.

7. Paragraph 23 of IAS 8 explains that when retrospective application is required, a change in accounting policy shall be applied retrospectively except to the extent that it is impracticable to determine either the period-specific effects or the cumulative effect of the change. Paragraph 24 of IAS 8 explains that when it is impracticable to determine the period-specific effects of changing an accounting policy on comparative information for one or more prior periods presented, the entity shall apply the new accounting policy to the carrying amounts of assets and liabilities as at the beginning

of the earliest period for which retrospective application is practicable, which may be the current period. Paragraph 25 of IAS 8 explains that when it is impracticable to determine the cumulative effect, at the beginning of the current period, of applying a new accounting policy to all prior periods, the entity shall adjust the comparative information to apply the new accounting policy prospectively from the earliest date practicable.

8. Paragraph 28 of IAS 8 contains disclosure requirements on initial application of an IFRS Accounting Standard (or amendments thereto), including:

   (a) the title of the IFRS;

   (b) when applicable, that the change in accounting policy is made in accordance with its transitional provisions;

   (c) the nature of the change in accounting policy;

   (d) when applicable, a description of the transitional provisions;

   (e) when applicable, the transitional provisions that might have an effect on future periods;

   (f) for the current period and each prior period presented, to the extent practicable, the amount of the adjustment:

      (i) for each financial statement line item affected; and

      (ii) if IAS 33 *Earnings per Share* applies to the entity, for basic and diluted earnings per share;

   (g) the amount of the adjustment relating to periods before those presented, to the extent practicable; and

   (h) if retrospective application is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied.

9. Paragraph 50-53 of IAS 8 discuss impracticability in respect of retrospective application:

> In some circumstances, it is impracticable to adjust comparative information for one or more prior periods to achieve comparability with the current period. For example, data may not have been collected in the prior period(s) in a way that allows either retrospective application of a new accounting policy…and it may be impracticable to recreate the information. […]
>
> Therefore, retrospectively applying a new accounting policy or correcting a prior period error requires distinguishing information that:
>
> (a) provides evidence of circumstances that existed on the date(s) as at which the transaction, other event or condition occurred, and
>
> (b) would have been available when the financial statements for that prior period were authorised for issue
>
> from other information. For some types of estimates (eg a fair value measurement that uses significant unobservable inputs), it is impracticable to distinguish these types of information. […]
>
> Hindsight should not be used when applying a new accounting policy to, or correcting amounts for, a prior period, either in making assumptions about what management's intentions would have been in a prior period or estimating the amounts recognised, measured or disclosed in a prior period.[...]

Entities already applying IFRS Accounting Standards

The transition method

10. The transition method directly affects the time, effort and cost for an entity to adapt to new financial reporting requirements. Retrospective application is generally the

default approach required by IFRS Accounting Standards; exceptions are made in some circumstances. Users of financial statements generally prefer entities to apply new requirements retrospectively to all periods presented to facilitate year-on-year comparison of results. However, retrospective application can sometimes be costly for preparers and in some cases is impracticable such as when the information needed for prior periods is not available or hindsight would be required to transition to new requirements.

11. In making decisions about transition methods, and in balancing the benefits and costs of retrospective application, the IASB may decide:

    (a) to limit the extent to which entities need to revise previously issued financial information (the 'limited or modified retrospective method');

    (b) to require the new IFRS Accounting Standard to apply only to transactions and events that occur after the effective date (the 'prospective method'); or

    (c) to delay the effective date, thereby enabling entities to accumulate cost-effectively the data needed to produce comparative information.

12. The staff note the basic premise that classification of issued financial instruments in the scope of IAS 32 is based on the contractual terms and conditions at the date the contract was entered into. We then considered the appropriateness of the different transition methods in the light of the proposed amendments to classification, presentation and disclosures.

13. Prospective application would require an entity to apply the proposed amendments only to financial instruments issued after the proposed amendments are first applied. Prospective application is generally only appropriate in situations where:

    (a) it is not practicable to apply the provisions of an IFRS Accounting Standard retrospectively to all prior periods because of operational challenges;

    (b) the costs of obtaining the information required for retrospective application would outweigh any benefits to investors;

(c) the provisions of the IFRS Accounting Standard apply to discrete nonrecurring events or transactions; and/or

(d) proposals are materially different from the existing requirements.

14. Overall, the staff believe the reasons listed in paragraph 13 of this paper are not generally applicable to the proposed amendments ie the proposed amendments would not necessitate prospective application. In addition, prospective application would decrease comparability and may be misleading to users of financial statements. This is because similar instruments would be classified differently depending on when they were issued due to applying the underlying principles in IAS 32 differently.

15. Applying the modified retrospective method, an entity would apply the proposed amendments retrospectively in accordance with IAS 8 except not be required to restate prior periods. The entity may restate prior periods if, and only if, it is possible without the use of hindsight and the restated financial statements reflect all the requirements. If an entity does not restate prior periods, it recognises the cumulative effect of initially applying the amendments at the date of initial application (ie the start of the reporting period in which an entity first applies the amendments). The cumulative effect is recognised as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) of the annual reporting period that includes the date of initial application.

16. The staff think a modified retrospective approach would be more suitable when there has been only a change in recognition and measurement requirements and not also new presentation and disclosure requirements. The tentative decisions to date on presentation and disclosures represent significant changes to the financial statements and users of financial statements would benefit from comparability in prior periods.

17. The staff therefore recommend retrospective application of the proposed amendments as if they had always been required and restating comparative information. This would maximise consistency of financial information between periods and also facilitate analysis and understanding of comparative information. Retrospective

application is also consistent with the transition requirements of previous amendments to IAS 32 for example, the amendments for puttable financial instruments and obligations arising on liquidation and offsetting financial assets and financial liabilities.

18. The staff are of the view that the benefits of retrospective application would outweigh the costs because:

    (a) the proposals related to classification are not materially different from the existing requirements because the objective of the project is to make clarifying amendments to the underlying principles in IAS 32 rather than to fundamentally change any requirements;

    (b) comparative information would help users of financial statements identify and assess changes and trends in the entity's liquidity and solvency; and

    (c) the costs of obtaining the information related to the classification proposals are not expected to be excessive as most information should be readily available to preparers based on their information technology systems today.

The need for transition relief

19. IAS 8 provides relief when it is impracticable to apply a change in accounting policy arising from new requirements retrospectively (see paragraph 7 of this paper). The staff are of the view that, in most cases, entities should be able to apply the amendments retrospectively because most of the information needed to apply the classification, presentation and disclosure proposals would largely be available. The classification continues to be based on the contractual terms and conditions at the date of issue and reclassification is generally prohibited. However, the staff considered whether specific transition relief would be required based on the IASB's tentative decisions on the various topics addressed as part of the scope of the FICE project. Specifically, the staff considered in which circumstances it might be impracticable to apply the proposed amendments retrospectively.

20. Broadly, the tentative decisions made to date as part of the FICE project, summarised in Agenda Paper 5A of this meeting, and any tentative decisions made at this meeting can be grouped into two categories:

    (a) Clarifications made to classification requirements; and

    (b) New presentation and disclosure requirements.

Clarifications made to classification requirements

21. The proposed amendments to IAS 32 related to classification are clarifications to the underlying principles rather than clarifications that merely confirm existing accounting requirements. One of the objectives of the FICE project is to address known practice issues that arise when applying IAS 32 by clarifying the underlying principles without making fundamental changes to the requirements. The staff acknowledge that addressing accounting diversity by clarifying relevant classification principles, would necessarily mean that some entities might need to change their accounting policies when initially applying the proposed amendments. This in turn might require a retrospective change in classification for some of their issued financial instruments. Therefore, some instruments currently classified as financial liabilities may need to be retrospectively accounted for as equity instruments and vice versa.

22. A retrospective change in classification of financial instruments as financial liabilities or equity would affect their recognition and measurement. This is because equity instruments are not remeasured. However, for financial liabilities:

    (a) interest, coupons or non-discretionary dividends paid to holders are recognised in profit or loss.

    (b) IFRS 9 *Financial Instruments* requires the carrying amount to be adjusted to reflect the expected timing and amount of future cash flows. Although different requirements would apply depending on whether the financial liability is measured at amortised cost or at fair value through profit or loss, the carrying amount of the financial liability is remeasured and changes in the carrying amount are recognised in profit or loss.

(c) gains or losses on derecognition of financial liabilities are recognised in profit or loss.

23. Depending on how entities previously applied the requirements in IAS 32, the staff think a change in classification could arise from applying, for example:

(a) the proposed foundation and adjustment principles to determine if the fixed-for-fixed condition is met for derivatives on own equity;[1]

(b) the proposed principle in determining whether rights and obligations arising from a legal requirement are considered in the classification;

(c) the factors an entity should consider in assessing whether a shareholder decision is treated as an entity decision and therefore whether an entity has an unconditional right to avoid delivering cash (or settling a financial instrument in such a way that it would be a financial liability);

(d) the proposed clarifications to the accounting for instruments containing obligations to redeem own equity instruments that are settled in a variable number of a different type of the entity's own equity; and

(e) the proposed amendments which prohibit reclassification other than for changes in the substance of the contractual terms arising from changes in circumstances outside the contract.

24. Depending on how entities previously applied the requirements in IAS 32, the staff think a change in measurement could arise from, for example:

(a) the proposed clarification that the financial liability component of a compound instrument with a contingent settlement provision should be initially measured at the full amount of the conditional obligation and entities should use 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.

same approach for subsequent measurement ie ignore the probability and estimated timing of the contingent event; and

(b) the proposed clarification that entities should use the same approach for initial and subsequent measurement of financial liabilities representing obligations to redeem own equity instruments ie ignore the probability and estimated timing of the holder exercising the written put option.

25. The staff also think the proposed clarifications to accounting for obligations to redeem own equity instruments could result in a change in the presentation of amounts within equity, for example:

(a) if the entity does not already have access to the returns associated with an ownership interest and the initial recognition of the obligation to redeem own equity instruments was recognised against non-controlling interests or issued share capital instead of another component of equity;

(b) if gains or losses on remeasuring the financial liability were recognised in equity instead of in profit or loss;

(c) depending on which component of equity was credited when the financial liability was removed on expiry of a written put option on the entity's own equity instruments; and

(d) depending on whether or not the cumulative amount in retained earnings related to remeasuring the financial liability was reversed in profit or loss.

26. For changes that require remeasurement of the financial liability to the full amount or present value of the redemption amount (see paragraph 24 of this paper), and for changes that require restatements within equity (see paragraph 25 of this paper), the staff think that it would not be impracticable to apply the changes retrospectively.

27. For changes in classification from equity instruments to financial liabilities upon initial application of the proposed amendments, the staff think some entities could face difficulties in applying the proposed amendments retrospectively as:

(a) hindsight might be required to determine the fair value (on initial recognition or subsequently) retrospectively. For example, it may be impracticable to determine the fair value of options on equity instruments retrospectively. These options are reported in level 3 of the fair value hierarchy if equity instruments are measured primarily using entity business plans and entity-specific discount rates.

(b) hindsight might be required to determine the effective interest rate or apply the effective interest method retrospectively.

28. The staff note that paragraphs 23-27 of IAS 8 provide relief when it is impracticable to apply new requirements retrospectively. The staff do not recommend additional guidance for when it is impracticable to determine the fair value of a financial liability retrospectively. In applying the IAS 8 relief, an entity would determine the fair value of the financial liability at the beginning of the earliest period for which retrospective application is practicable without using hindsight. Any difference between the previous carrying amount and the fair value shall be recognised in the opening retained earnings (or other component of equity, as appropriate) of the beginning of the earliest period for which retrospective application is practicable.

29. However, the staff recommend the following specific transition relief would be useful to preparers for equity instruments that should have been classified as financial liabilities: where it is impracticable (as defined in IAS 8) to apply the effective interest method retrospectively prior to the beginning of the earliest comparative period presented, the fair value at the beginning of the earliest comparative period presented would be treated as the amortised cost of the financial liability at that date.

30. For financial liabilities that should have been classified as equity, entities would need to determine the original issue price of the financial instrument and reverse the remeasurement on the financial liability against retained earnings. The staff note that retained earnings belongs to the ordinary shareholders and not to other equity holders so it would be important to determine the original issue price in the light of the

proposed presentation requirements. However, the staff think the original issue price can be determined so we do not propose any transition relief for these instruments.

31. In addition, similar to the transition provision in IFRS 1 *First-time Adoption of International Financial Reporting Standards* (see paragraph 47 of this paper) and in paragraph 97C of IAS 32, the staff recommends an entity not be required to separate a compound financial instrument with a contingent settlement provision into separate liability and equity components if the liability component is no longer outstanding at the date of initial application of the amendments. If the proposed amendments are applied retrospectively, a compound instrument with a contingent settlement provision which could require settlement on a specified date in the future will have to be separated into liability and equity components from the instrument's inception. It may be that for some instruments the liability component is no longer outstanding at the date of initial application of the proposed amendments and, consequently, separating these compound financial instruments would have no benefit because retrospective application would involve separating two components of equity.

32. The staff will also include a question in the forthcoming Exposure Draft to identify other cases where retrospective application would require hindsight.

New presentation and disclosure requirements

33. 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. The IASB was of the view that this could be achieved by improving the presentation and disclosure requirements instead of relying solely on a binary classification of financial instruments to provide useful information about similarities and differences between the instruments an entity issued.

34. The IASB's tentative decisions to amend the presentation requirements in IAS 1 are in response to the needs of users of financial statements, particularly investors in ordinary shares, for a clear distinction of the returns to ordinary shareholders. The proposed presentation requirements would make amounts attributable to *ordinary*

shareholders more visible in the statement of financial position, the statement of comprehensive income and the statement of changes in equity.

35. The staff's proposals in Agenda Paper 5B of this meeting and the IASB's tentative decisions on disclosures have been developed after considering the need to balance the requests from users of financial statements with the concerns of preparers of financial statements. For example, the proposed disclosures on priority on liquidation, terms and conditions and potential dilution (including their scope and level of detail) were developed after considering additional research and feedback from specific outreach on potential refinements to these disclosures with equity and debt analysts, preparers and accounting standard setters. In particular, the IASB considered concerns from stakeholders about disclosure overload and practical difficulties in obtaining or preparing that information.

36. The IASB also specifically considered feedback from investors in ordinary shares of companies when it tentatively decided not to change the classification of perpetual instruments containing obligations that arise only on liquidation but to develop presentation and disclosure requirements to meet their information needs.

37. Retrospective application of the proposed presentation and disclosure requirements would provide useful information that enhances consistency and comparability. The staff do not think any specific transition relief for these proposed requirements is needed because the expected benefits of retrospective application would outweigh the expected costs. The staff acknowledge, however, that if retrospective application is required, entities would need sufficient time for implementation because some of the information may not currently be captured by the systems today or may be more difficult to report at the level of granularity required for example, the new proposed disclosures on priority on liquidation, terms and conditions and potential dilution. Retrospectively reporting this information is important for entities to reflect how they manage their activities and risk exposures. Similar to some of the existing disclosures in IFRS 7, disclosures should be based on the information provided internally to key

management personnel of the entity (as defined in IAS 24 *Related Party Disclosures),* for example the entity's board of directors or chief executive officer.

Disclosure requirements on transition

38. An entity is required to apply the disclosure requirements of IAS 8 unless another IFRS Accounting Standard specifies otherwise. When initially applying the proposed amendments, the disclosures in paragraph 28 of IAS 8 (see paragraph 8 of this paper) would thus apply.

39. The staff recommend entities not be required to disclose the quantitative information required by paragraph 28(f) of IAS 8. The cost of providing this disclosure would exceed the benefits particularly because clarifying the underlying principles in IAS 32 could affect many line items throughout the financial statements based on the current diversity in practice of applying some requirements in IAS 32 to various complex financial instruments.

40. In addition, the staff recommend specific transition disclosures in IFRS 7 where there has been a change in classification resulting from initial application of the proposed requirements. The staff think it will be particularly beneficial to highlight such changes to users of financial statements. The staff recommend requiring an entity to disclose the following information as at the beginning of the earliest comparative period or the date of initial application (if the change in classification only affects the prior year):

    (a) the previous classification and carrying amount determined immediately before applying the proposed amendments; and

    (b) the new classification and carrying amount determined after applying the proposed amendments.

    The disclosures need not be made in subsequent annual reporting periods.

Interim periods

41. Without specific transition relief, the requirements in IAS 34 would apply to interim financial reports issued within the annual period in which an entity first applies the amendments. Paragraph 15 of IAS 34 states:

> An entity shall include in its interim financial report an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the entity since the end of the last annual reporting period. Information disclosed in relation to those events and transactions shall update the relevant information presented in the most recent annual financial report.

42. Paragraph 16A(a) of IAS 34 requires a statement that the same accounting policies and methods of computation are followed in the interim financial statements as compared with the most recent annual financial statements or, if those policies or methods have been changed, a description of the nature and effect of the change.

43. In addition, paragraph 16A of IAS 34 requires the following information related to financial instruments, amongst others, to be disclosed in the notes to the interim financial statements or elsewhere in the interim financial report:

    (a) issues, repurchases and repayments of debt and equity securities;

    (b) dividends paid (aggregate or per share) separately for ordinary shares and other shares.

    (c) the disclosures about fair value required by paragraphs 91–93(h), 94–96, 98 and 99 of IFRS 13 *Fair Value Measurement* and paragraphs 25, 26 and 28–30 of IFRS 7.

44. The staff acknowledge that:

    (a) the proposed clarifications to relevant classification principles, would necessarily mean that some entities might need to change their accounting

policies when initially applying the proposed amendments. This in turn might require a retrospective change in classification for some of their issued financial instruments.

45. The proposed presentation and disclosure requirements are significant. As explained in paragraphs 34-36 of this paper, the proposed presentation and disclosure requirements have been developed in response to direct feedback from users of financial statements about what information would be needed for their analysis of the claims against an entity.

46. However, the staff do not recommend any specific transition relief from the requirements of IAS 34 for interim financial reports issued within the annual period in which an entity first applies the amendments. The staff note that no specific transition relief for interim financial reports was given in other IFRS Accounting Standards such as IFRS 9 or IFRS 16 *Leases*. An entity would therefore need to apply judgement in determining what to disclose regarding the nature and effect of changes in accounting policies and how much information to provide to update the relevant information presented in the most recent annual financial report.

First-time adopters

47. Applying IFRS 1, a first-time adopter is required to apply the requirements of IAS 32 retrospectively except for the optional exemption permitted for compound instruments. Paragraph D18 of IFRS 1 allows an exemption from the requirement to split a compound financial instrument at inception into separate liability and equity components if the liability component is no longer outstanding at the date of transition to IFRS Accounting Standards.

48. Similar to entities already applying IFRS Accounting Standards, a first-time adopter may also face hindsight challenges in applying the proposed amendments affecting classification retrospectively (see paragraph 2726 of this paper). To ensure that similar transition exemptions are available for first-time adopters, the staff recommend the following transition relief would be useful to first-time adopters: where it is

impracticable (as defined in IAS 8) to determine the fair value of a financial liability prior to the date of transition, an entity would use the fair value at the date of transition. Any difference between the previous carrying amount and the fair value shall be recognised in the opening retained earnings (or other component of equity, as appropriate) at the date of transition.

49. This proposed transition relief is necessary because, unlike entities already applying IFRS Accounting Standards, the requirements on changes in accounting policies in IAS 8 would not apply to first-time adopters (see paragraph 28 of this paper).

50. The staff note that paragraph B8C of IFRS 1 already contains a transition exemption where it is impracticable (as defined in IAS 8) for an entity to apply the effective interest method in IFRS 9 retrospectively. This exemption is similar to the transition relief proposed for entities already applying IFRS Accounting Standards (see paragraph 29 of this paper) and therefore no further transition relief related to classification is necessary for first-time adopters.

51. Paragraph 20 of IFRS 1 explains that IFRS 1 “does not provide exemptions from the presentation and disclosure requirements in other IFRS Accounting Standards.” Therefore, the staff are of the view that no specific transition exemptions are needed for the proposed presentation and disclosure requirements for first-time adopters.

Effective date

52. In the staff’s view, an effective date would be best determined after exposure of the proposed amendments to allow more flexibility in finalising the proposed amendments. However, we recommend that early application of the amendments is permitted as that would result in earlier reporting of improved information to users of financial statements. If an entity applies these proposed amendments for an earlier period, it shall disclose that fact and apply all of the proposed amendments at the same time.