IFRS Accounting

Staff paper

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IASB® meeting

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Project	**Financial Instruments with Characteristics of Equity (FICE)**
Topic	**Classification and Presentation: Sweep Issues (Part A)**
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Purpose and structure

1. The purpose of this paper and Agenda Paper 5B of this meeting is to consider several sweep issues the staff became aware of subsequent to the IASB's discussions in 2020-2022 on classification and presentation topics included in the FICE project plan. We are asking the IASB whether it agrees with our recommendations to make further clarifications related to classification and presentation as summarised in paragraph 4 of Agenda Paper 5 of this meeting.

2. This paper is structured as follows:

   (a) Classification sweep issues

      (i) Fixed-for-fixed condition;

      (ii) Shareholder discretion; and

      (iii) Reclassification.

3. For each sweep issue, the staff set out our analysis and/or recommendation and a question for the IASB.

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Classification sweep issues

Fixed-for-fixed condition

Staff analysis

4. In April 2020, the IASB discussed potential clarifications to the fixed-for-fixed condition for classifying derivatives on own equity making use of a foundation principle (Agenda Paper 5A) and an adjustment principle (Agenda Paper 5B).[1] The IASB made the following tentative decisions:
   (a) for a derivative on own equity to meet the fixed-for-fixed condition in IAS 32 *Financial Instruments: Presentation*, the number of functional currency units to be exchanged with each underlying equity instrument must be fixed or only vary with:
      (i) allowable preservation adjustments; or
      (ii) allowable passage of time adjustments.
   (b) to classify as equity a contract that can be settled by exchanging a fixed number of non-derivative own equity instruments with a fixed number of another type of non-derivative own equity instruments.

5. Subsequent to the tentative decision, a few stakeholders asked about the classification of convertible bonds where the holder has a choice between two fixed conversion ratios, each involving a different type of own shares. For example, Subsidiary X issues convertible bonds for CU1 million with a maturity date of June 2026. The holder has the right to convert the bonds, at any time before maturity, into either 100 shares of Parent company Y or 1,100 shares of Subsidiary X.

[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.

6. The question is whether the conversion option meets the fixed-for-fixed condition in the consolidated financial statements. In this fact pattern, the conversion ratios have been predetermined and fixed upfront per type of own share ie the number of functional currency units to be exchanged for each X share or each Y share is fixed but the issuer does not know whether settlement will be in X shares or Y shares. There are no preservation or passage of time adjustments.

7. The IASB previously discussed examples of predetermined ratios. The April 2020 Agenda Paper 5A contained a similar example except in both cases Entity X shares were being exchanged: "Entity X issues a call option that gives the holder a choice between two predetermined 'fixed-for-fixed' exchanges, for example, to deliver 100 of its own shares for CU110 or 50 of its own shares for CU55. Applying the foundation principle in this case, Entity X knows how many currency units it is entitled to receive per share if the option is exercised, being CU1.10 per share. The ratio of own equity instruments delivered in exchange for an amount of cash is fixed. In the absence of any other feature that precludes equity classification, the derivative on own equity in this example would be classified as an equity instrument."

8. The December 2019 Agenda Paper 5 contained an example of predetermined ratios where both the number of the issuer's shares and the amount of cash changes: if A occurs the holder will receive 100 issuer shares for CU100, but if B occurs the holder will receive 75 issuer shares for CU90. Applying the foundation principle, the fixed-for-fixed condition would not be met because the entity would not know how many currency units it is entitled to receive per share.

9. However, in the fact pattern described in paragraph 5 of this paper, the predetermined ratios relate to two different types of own shares in the group ie X shares or Y shares. The staff think these types of predetermined ratios should not preclude equity classification in the consolidated financial statements for the following reasons:

   (a) the outcomes are mutually exclusive ie there is only one conversion option to exercise and if the holder chooses one type of own shares, the other type of

own shares can no longer be received. Applying the foundation principle, both outcomes on their own would meet the fixed-for-fixed condition:

(i) the issuer knows at inception of the derivative, how many functional currency units it is entitled to receive *per type of own share* exchanged if the option is exercised.

(ii) the issuer's rights and obligations are fixed *per type of own share* and they do not vary with any variable including the price of the underlying equity instruments. This is similar to how the issuer's rights and obligations would have been fixed if it had issued each type of own shares for cash instead.

(b) the difference in value between X and Y shares is irrelevant if the assessment is focused on each type of own share because the fixed-for-fixed condition does not require an assessment of whether the pricing of a derivative is reasonable. The focus is on whether there is variability in contractual rights and obligations ie variability in the number of functional currency units to be exchanged for each equity instrument rather than the actual value received per share.

(c) paragraph 26 of IAS 32 deals with settlement options in derivatives: "When a derivative financial instrument gives one party a choice over how it is settled (eg the issuer or the holder can choose settlement net in cash or by exchanging shares for cash), it is a financial asset or a financial liability unless all of the settlement alternatives would result in it being an equity instrument." Although this paragraph typically covers settlement options such as settlement net in cash, net in shares or an exchange of cash and shares, the staff are of the view that those are just examples. Paragraph BC20 of the Basis for Conclusions on IAS 32 explains that the IASB concluded that entities should not be able to circumvent the accounting requirements for financial assets and financial liabilities simply by including an option to settle a contract through the exchange of a fixed number of shares for a fixed amount. In this case, applying

paragraph 26 of IAS 32, both options the holder could choose from would result in an exchange of a fixed number of shares for a fixed amount.

(d) it could be argued that in substance there are two transactions— for example the exchange of a fixed amount of cash for a fixed number of X shares, and then the exchange of a fixed number of X shares for a fixed number of Y shares, both of which would result in equity classification, applying the principles tentatively agreed to by the IASB.

Staff recommendation

10. The staff recommend clarifying that the foundation principle is met if the entity knows how many functional currency units it is entitled to receive **per type of** own share if the option is exercised.

Question for the IASB

Question for the IASB
1. Does the IASB agree with the staff's recommendation as set out in paragraph 10 of this paper?

Shareholder discretion

Staff analysis

11. In February 2022 (Agenda Paper 5B), the IASB discussed the classification of a financial instrument with a contractual obligation to deliver cash (or to settle it in such a way that it would be a financial liability) at the discretion of the issuer's shareholders.

12. This topic was subject to much debate from IASB members, particularly because there are many different contractual terms and facts and circumstances that vary from one instrument to another. Due to the large amount of inherent judgement needed in

such classification decisions, it would be difficult for a single principle to be applied consistently to different financial instruments across all jurisdictions.

13. The IASB tentatively decided to explore a factors-based approach to help an entity apply its judgement when classifying these types of financial instruments as financial liabilities or as equity. Such an approach would provide examples of potential factors for an entity to consider when assessing whether a decision of shareholders is treated as a decision of the entity. This assessment is needed to determine 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).

14. Applying this approach an entity would need to consider all relevant factors in its assessment. A factor might not be determinative on its own but could be an indicator that a decision by shareholders should be treated as a decision by the entity. Different weightings would be applied because some factors may be more or less relevant depending on the particular facts and circumstances and the terms and conditions of the specific contract. Different factors may provide more persuasive evidence in different circumstances.

15. Seven of 12 IASB members tentatively agreed with the decision and the staff agreed to bring back some draft wording to a future meeting so that IASB members could be more comfortable with the proposed approach.

16. The wording below reflects the staff's current thinking of how to articulate the factors discussed by the IASB in February 2022:

> Factors that an entity could consider when making that assessment include:
>
> (a) whether a shareholder decision would be routine in nature, that is, in the normal course of the entity's business activities in accordance with the entity's established operating and corporate governance procedures.

(b) whether a shareholder decision relates to an action that would be proposed by the entity's management.

(c) whether different classes of shareholders would benefit differently from a shareholder decision.

(d) whether the exercise of a shareholder decision-making right would enable those shareholders to require redemption of (or payment of a return on) their shares in cash or another financial asset (or other settlement in such a way that it would be a financial liability).

The factors set out are examples of factors that an entity could consider when assessing whether a shareholder decision is treated as a decision of the entity. Other factors may be pertinent to that assessment. The weightings applied to each factor when making that assessment depends on the specific facts and circumstances.

17. The staff highlight that the use of the words 'factors that an entity *could* consider' means that the entity is not required to consider those factors, ie they are optional.

18. However, the staff are of the view that the risk of entities manipulating the assessment (ie disregarding these factors even when they are relevant) to achieve a desired classification outcome would be mitigated by the requirement in paragraph 122 of IAS 1 *Presentation of Financial Statements* to disclose the judgements that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements. Paragraph 5 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* defines accounting policies as the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements. Entities would therefore be required to disclose the judgements made in applying the factors-based approach and in making the assessment of whether a shareholder decision is treated as a decision of the entity. The staff think the

proposed factors are common factors that would often be relevant and their consideration in that assessment would help reduce diversity in practice.

19. The staff also plan to consider whether any additional disclosures should be included in IFRS 7 *Financial Instruments: Disclosures* to require entities to disclose particular judgements made in classifying these and other types of issued financial instruments at a future meeting when we circle back on disclosures. At that future meeting, the staff will also consider more comprehensively whether any further disclosures are required as a result of the potential clarifications made to classification and presentation topics in the FICE project.

20. The proposed amendment would make it clear that:

    (a) there is a requirement to perform an assessment ie to determine whether a shareholder decision is treated as a decision of the entity and ultimately whether an entity has the unconditional right to avoid liability-type settlement of a financial instrument; and

    (b) significant judgement would be required in making that assessment based on the specific facts and circumstances and terms and conditions of the specific contract.

21. The staff think it will be important to clarify the objective of the proposed amendment in the Basis for Conclusions in the forthcoming ED, and why the factors are optional:

    (a) the objective is to help entities apply their own judgement in making that assessment based on the contractual terms and conditions, facts and circumstances.

    (b) the factors are optional so that they do not limit or constrain in any way an entity's judgements in making its assessment. The assessment requires significant judgement to be applied on a case-by-case basis. There is not one factor that works in all situations, some are relevant in some cases but not in others or there may be additional relevant factors. For that reason, the factors

are not intended to be an exhaustive list but rather represent common factors that would often be relevant.

Question for the IASB

Question for the IASB
2. Do IASB members have any comments or questions on the draft articulation of the proposed factors to consider?

Reclassification

Staff analysis—reference to 'reclassification'

22. In March (Agenda Paper 5) and June 2022 (Agenda Papers 5A and 5B), the IASB discussed reclassification of issued financial instruments as financial liabilities or equity instruments when the substance of the contractual terms changes without a modification to the contract. The staff noted that in practice the term 'reclassification' is sometimes used synonymously with derecognition. We analysed the difference between derecognition and reclassification and 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.

23. In June 2022, the IASB tentatively decided to add *general* requirements on reclassification to IAS 32 to prohibit reclassification other than for changes in the substance of the contractual terms arising from *changes in circumstances* outside the

contract. This approach does not affect reclassifications already required in IAS 32. 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').

24. The staff note that 'reclassification' is also mentioned in paragraph 23 of IAS 32 which discusses the accounting on initial *recognition* and expiry (*derecognition*) of a contract containing an obligation for an entity to purchase its own equity instruments for cash or another financial asset. It requires:

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

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

Staff recommendation—reference to 'reclassification'

25. To avoid the term 'reclassification' being used inconsistently in IAS 32 with the existing requirements for reclassification of puttable instruments and obligations arising on liquidation and the proposed amendments on reclassification, the staff recommend replacing 'reclassified' with 'transferred' and 'reclassification' with 'transfer' in paragraph 23 of IAS 32.

Staff analysis—date of reclassification

26. In June 2022, the IASB also tentatively decided to clarify that a reclassification applying the proposed general requirements would be accounted for *in the reporting period* in which the change in circumstances occurred. However, the IASB did not reach a decision on whether to require reclassification:

    (a) at the date of the change in circumstances; or

(b) at the end of the reporting period.

The IASB directed the staff to further consider this issue.

27. Based on the IASB's tentative decision to require reclassification for a change in circumstances, continuous reassessment would effectively be required. However, the staff expect the circumstances outside the contract that would trigger reclassification to be less frequent. We would therefore not expect there to be multiple trigger events resulting in multiple reclassifications within a reporting period.

28. During the June 2022 meeting, IASB members also discussed an alternative approach of requiring reclassification **at the date of the change in circumstances but if that date cannot be determined, then requiring reclassification at the end of the reporting period**. Reclassification at the end of the reporting period was therefore expressed as being a 'backstop' if the entity could not determine the date of the change in circumstances. Some IASB members thought that could work, while others thought allowing a 'backstop' would be too subjective and the IASB should either propose reclassification at the date of a change in circumstances or at the end of the reporting period. The staff think such alternative approach would be difficult to achieve consistent application in practice.

29. The staff considered that an approach requiring reclassification **at the end of the reporting period** would be simpler and less costly for preparers to apply because it would avoid:

(a) the recognition and measurement consequences of reclassifying during the reporting period but still reflect the correct classification of the financial instrument at the reporting date. The classification at the end of the reporting period is often more important to users of financial statements. This is because it would affect calculations such as net debt and other ratios involving balances of financial liabilities or equity.

(b) any possible practical difficulties of determining the date of the change in circumstances.

30. However, the staff think reclassification **at the date of the change in circumstances** would provide information to users of financial statements that is both relevant and most faithfully represents the substance of the contractual terms, *throughout the reporting period* and not just at the reporting date. The date of the reclassification would not depend on the frequency of reporting which would be the case if reclassification was only accounted for at the end of the reporting period in which the change in circumstances occurs or at the beginning of the first reporting period after the change in circumstances.

31. In the June 2022 meeting, most IASB members initially indicated they would prefer reclassification when the change in circumstances occurs. However, IASB members also discussed whether there were any practical considerations with such an approach—in particular:

    (a) whether it was always clear when the change in circumstances occurs; and

    (b) whether entities could choose a date to achieve an accounting result.

32. The staff continue to believe that the most common examples of changes in circumstances that would require reclassification would be:

    (a) changes in an entity's functional currency or changes to the entity's organisational structure which affect the classification of *derivatives or embedded derivatives on own equity* applying the fixed-for-fixed condition; and

    (b) the issue or settlement of 'linked instruments' which affect the payments to be made on and therefore the classification of *non-derivative* financial instruments.

33. The staff further considered whether there could be practical difficulties in determining the date of change in circumstances in these cases. In the case of linked instruments, the change in circumstances will coincide with the date a linked instrument is issued or settled.

34. When there is a change in an entity's functional currency, paragraph 35 of IAS 21 *The Effects of Changes in Foreign Exchange Rates* requires an entity to apply the translation procedures prospectively from the date of the change. 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. The staff acknowledge that change to the underlying transactions, events and conditions would not necessarily occur on a specific date. However, the entity needs to determine the date of a change in functional currency to comply with IAS 21 and therefore that date would also be used for reclassification purposes.

35. Paragraph 20 of IFRS 10 *Consolidated Financial Statements* requires consolidation of an investee to begin from the date the investor obtains control of the investee and to cease when the investor loses control of the investee. Paragraph 8 of IFRS 10 explains that an investor reassesses whether it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control. The staff acknowledge that although the date of a change in control may be determined to be the completion date of the disposal or acquisition of a subsidiary, judgement may be required in assessing when there has been a change to one or more of the elements of control and determining that completion date may not be so straightforward. However, the entity needs to determine the date of a change in control to comply with IFRS 10 and therefore that date would also be used for reclassification purposes.

36. The following arguments further support reclassification **at the date of the change in circumstances** and take into consideration IASB member comments from the June 2022 meeting:

(a) users of financial statements receive information that faithfully represents the substance of the contractual terms throughout the reporting period, including at the reporting date. Reclassification between equity and financial liabilities substantially affects the structure of the statement of financial position and therefore the understandability of financial statements as a whole. Reclassification during the reporting period would affect the measurement of

interest and may result in a mixed presentation during the period between interest and dividends.

(b) internal consistency with the reclassification requirements for puttable instruments and obligations arising on liquidation. Paragraph 16F of IAS 32 requires reclassification from the date when the instrument has or ceases to have all the features and/or meets or ceases to meet all the conditions set out in paragraphs 16A-16B or 16C-16D of IAS 32. For example, if an entity redeems all its issued non-puttable instruments and any puttable instruments that remain outstanding have all the features and meet all the conditions in paragraphs 16A and 16B, the entity reclassifies the puttable instruments as equity instruments from the date when it redeems the non-puttable instruments.

(c) limited risk of entities choosing a reclassification date to achieve an accounting result. The proposed IAS 32 reclassification requirements would be applied on an instrument-by-instrument basis. Further, the IASB tentatively decided that reclassification will not result in recognition of a gain or loss in profit or loss on reclassification which helps to mitigate the risk.

Staff recommendation—date of reclassification

37. Based on the staff's further analysis, the staff recommend reclassification at the date of the change in circumstances. However, the staff recommend asking a question in the forthcoming Exposure Draft to see if there are any practical considerations which would affect an entity's ability to determine the date of a change in circumstances or to reclassify at that date.

Question for the IASB

Question for the IASB
3. Does the IASB agree with the staff's recommendations as set out in paragraphs 25 and 37 of this paper?