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Staff paper

Agenda reference: 3

Global Preparers Forum meeting

Date	**1 March 2024**
Project	**Financial Instruments with Characteristics of Equity**
Topic	**Overview of the IASB’s proposals in the Exposure Draft**
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Purpose of this session

- Provide GPF members with an overview of the IASB's proposals in the Exposure Draft *Financial Instruments with Characteristics of Equity*. A snapshot and webcast series are also available on our website.
- Ask for views on those proposals, including:
  - whether they result in companies providing useful information about financial instruments with characteristics of equity;
  - whether there are any practical difficulties in implementing them; and
  - whether there are any unintended consequences.

Information for participants

Questions for GPF members

Questions for GPF members

1. Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

2. Are there practical difficulties and unintended consequences in implementing the proposals?

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Background information

Overview of the FICE project

Purpose

- Improve information entities provide in their financial statements about financial instruments they have issued
- Address challenges with applying IAS 32 *Financial Instruments: Presentation*

Approach

- Clarify underlying IAS 32 classification principles to address practice issues ('clarifying amendments'):
  - fixed-for-fixed condition for derivatives
  - effects of laws or regulations
  - obligations to purchase own equity instruments
  - contingent settlement provisions
  - shareholder discretion
  - reclassification
- Improve presentation and disclosure
- Provide application guidance and illustrative examples

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Next steps

29 Nov 2023
Exposure Draft published

29 Nov 2023–29 Mar 2024
Consultation period

Q2 2024 onwards
Feedback analysis and redeliberations

Link to the consultation:
https://www.ifrs.org/projects/work-plan/financial-instruments-with-characteristics-of-equity/exposure-draft-and-comment-letters/

Consultation closes
29 March 2024

Proposals in the Exposure Draft

Fixed-for-fixed condition for derivatives

For a contract to be classified as an equity instrument, the amount of consideration to be exchanged for each of an entity's own equity instruments shall be in the entity's **functional currency** and be either:

- fixed (that is, will not vary under any circumstances); or
- variable solely as a result of either a preservation adjustment or passage-of-time adjustment or both.

Adjustments	Requirements for equity classification
Preservation adjustments	Adjustments preserve economic interests of future shareholders to an equal or a lesser extent relative to economic interests of current shareholders
Passage-of-time adjustments	Adjustments: • are pre-determined at inception of the contract; • vary only with the passage of time; and • have the effect of fixing on initial recognition the present value of the amount of consideration exchanged for each of the entity's own equity instruments.

Perpetual instruments

'In good times, behaves like debt, in bad times, behaves like equity.'

- Stated coupon
- Issuer call option
- Coupon and principal can be deferred
- Subordinated/loss absorption

Regulatory Capital

Restricted Tier 1 (RT1)
Additional Tier 1 (AT1)

Corporate Hybrids

Utilities
Telecommunication
Oil and Gas
Automobile

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

What is the IASB proposing?

- No change in classification
- Develop presentation and disclosure requirements

Effects of laws or regulations on the contractual terms

Classify financial instruments as financial liabilities or equity by considering only contractual rights and obligations that are enforceable by laws or regulations and are in addition to those established by relevant laws or regulations.

Explicitly Stated Contractual Terms

Term		Example	Classification
Generally applicable regulatory requirements	**Example:**	General regulator powers in bail-in instrument	**Not consider in classification**
Contract terms in addition to those required by regulation	**Example:**	Specific loss absorption feature of bail-in instrument	**Consider in classification**

Terms not found in the contract

Term		Example	Classification
Laws prevent enforceability of contract terms	**Example:**	Law prohibits redemption feature	**Consider in classification**
Laws create obligations	**Example:**	Law mandates 10% of profits to be distributed as dividends	**Not consider in classification**

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 […]

What is the question?
When settlement of a contractual obligation is at the discretion of the issuer's shareholders, **is a decision of shareholders treated as a decision of the entity?**

The IASB is proposing a factors-based approach to help an entity apply judgement in determining whether it has an unconditional right to avoid delivering cash or another financial asset

- Factors required to consider:
  - Decision is routine in nature
  - Decision relates to an action proposed or transaction initiated by the entity's management for shareholder approval
  - Different classes of shareholders benefit differently from a shareholder decision
  - Exercise of a shareholder decision-making right enables a shareholder to require the entity to redeem or pay a return on its shares
- Weightings applied to each factor depend on specific facts and circumstances.
- Different factors may provide more persuasive evidence in different circumstances.

Reclassification between financial liabilities and equity instruments

IAS 32 requirements

- Paragraph 15 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 currently when there is a change in the substance of the contractual arrangement without a modification of the contract

Change in circumstances external to the contractual arrangement

Reclassification required prospectively from the date the change in circumstances occurs.

Changes when an existing contractual term becomes or stops being effective **with the passage of time**

Reclassification prohibited, disclosure required.

Contingent settlement provisions

Paragraph 25 of IAS 32

Example	Proposed amendments
Contingent convertible instrument: • Issued at par • Convertible into variable number of shares to the value of fixed par amount if CET 1 ratio breached • No maturity date • Discretionary dividends	• Financial instruments with contingent settlement provisions could be compound instruments. • Same approach for initial and subsequent measurement of financial liability—present value of the settlement amount—ignore probability and estimated timing of contingent event. • Discretionary payments recognised in equity, even if all proceeds are initially allocated to the liability component of a compound financial instrument. • ‘Liquidation’—process that begins after an entity has permanently ceased its operations. • ‘Not genuine’ assessment requires judgement—not based solely on probability or likelihood of the contingent event occurring.

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Paragraph 23 of IAS 32

Obligations to purchase own equity instruments

Example	Proposed amendments

Written put options on non-controlling interests (NCI) and forward purchase contracts	• Contractual obligation to purchase own equity instruments required to be presented on a gross basis—assists users of financial statements in assessing entity's exposure to liquidity risk.
	• If the entity does not yet have access to the rights and returns associated with ownership—initial amount of financial liability removed from component of equity other than NCI/issued share capital.
	• Gains or losses from remeasurement recognised in profit or loss.
	• Same approach for initial and subsequent measurement—present value of the redemption amount—ignore probability and estimated timing of holder exercising written put option.
	• Paragraph 23 applies also to obligations that could be settled in a variable number of another class of own equity.
	• On expiry of written put option:
	    • Include financial liability in same component of equity as that from which it was removed on initial recognition of put option; and
	    • Can transfer cumulative amount in retained earnings to another component of equity but not reverse in profit or loss.

Presentation—Proposed amendments to IAS 1

To ensure amounts attributable to ordinary shareholders are clearly visible on an entity's statement of financial position, statement(s) of financial performance and statement of changes in equity, an entity will be required to present:

Equity
- Ordinary shareholders of parent
- Other owners of the parent

Statement of financial position
- Line items on issued capital and reserves shown separately

Statement of financial performance
- Results attributable shown separately

Statement of changes in equity
- Each class of contributed equity shown separately
- Distributions shown separately

Disclosures

Not applicable to stand-alone derivatives

Terms & Conditions

- Debt-like characteristics
- Equity-like characteristics
- Characteristics that determine the classification

Priority on liquidation

- Nature and priority of claims against an entity
- T&Cs about priority on liquidation for particular instruments

Potential dilution

- Maximum number of additional ordinary shares
  - Reduced by minimum number of shares for repurchase

Other disclosures

- Significant judgements
- Reclassifications
- Remeasurement gains or losses on liabilities based on entity's performance/net assets
- Obligations to redeem own equity instruments
- Terms that become/stop being effective with passage of time
- Compound instruments–initial allocation between components

Scope of IFRS 7

Equity instruments issued

Transition

Fully retrospective with restatement of comparative information

1. Transition relief from some requirements
2. Disclosure of nature and amount of any changes in classification resulting from initial application
3. No specific relief from IAS 34 requirements for interim financial statements
4. No additional transition relief for first-time adopters

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