

## STAFF PAPER

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Project	Financial Instruments with Characteristics of Equity (FICE)		
Paper topic	Clarifying amendments to IAS 32 Project plan		
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## Introduction

1. At the September 2019 meeting of the International Accounting Standards Board (Board), the Board tentatively decided to consider making clarifying amendments to IAS 32 *Financial Instruments: Presentation*. Under this approach, the Board will focus on addressing practice issues by clarifying some underlying principles in IAS 32 and adding application guidance to facilitate consistent application of the principles.
2. The staff acknowledge that it may not always be clear in IAS 32 what the underlying principles are. This approach will aim to go further than interpreting the current wording in IAS 32. Under this approach, the Board will, when necessary, look to determine what the underlying principles should be so that the principles result in improved clarity and consistency with the rest of IAS 32. The Board will also consider whether such clarified principles would provide useful information and reduce accounting diversity. This approach is therefore broader than the work previously undertaken by the IFRS Interpretations Committee (Committee) but not as wide as the approach proposed in the Discussion Paper

*Financial Instruments with Characteristics of Equity* (2018 DP) or the approach that would be required as part of a more fundamental review of IAS 32.

3. At the same meeting, the Board also discussed what the project objectives should be and what criteria should be used to determine the scope of the project. As directed by the Board at that meeting, in this paper the staff set out the project plan. The project plan outlines the practice issues that the Board could address in this project. Deliberating those issues will help the Board determine whether there is a viable solution for achieving the project objectives and help the Board decide whether to add this project to its standard-setting agenda in the future.
4. This paper is structured as follows:
  - (a) Summary of the objectives of the clarifying amendments to IAS 32 (paragraph 6);
  - (b) Project plan—classification (paragraphs 7–64);
  - (c) Project plan—presentation and disclosure (paragraphs 65–68);
  - (d) Indicative project timeline (paragraph 69); and
  - (e) Question for the Board (paragraph 70).
5. Although the staff discuss the project plan for classification separately from the project plan for presentation and disclosure, both plans will run in parallel. We illustrate this in the indicative timeline in paragraph 69 of this paper.

### **Summary of the objectives of the clarifying amendments to IAS 32**

6. In developing the objectives of the clarifying amendments to IAS 32, the staff considered past challenges encountered by the Board such as in the past FICE projects and matters brought to the Committee. We also took into account the comments made by board members at the September 2019 Board meeting on the objectives that were presented in Agenda Paper 5 for that meeting. The overall objectives of the clarifying amendments to IAS 32 are to:
  - (a) address known practice issues that arise when applying IAS 32 by clarifying underlying principles in IAS 32 or improving the clarity of the articulation of those principles, if necessary. Where there is not an

implicit or explicit principle in IAS 32 for a particular requirement in IAS 32, the Board could fill this gap by developing a principle and accompanying rationale.

- (b) improve the information provided in the financial statements about the financial instruments issued by the entity;
- (c) limit changes to classification outcomes to those in which sufficient evidence exists that such a change would provide more useful information to users of financial statements. Such changes to classification outcomes may result from the following:
  - (i) addressing accounting diversity by clarifying relevant classification requirements, which would necessarily mean that some entities would need to change their accounting classification of a specific type of instrument.
  - (ii) reconsidering the current classification outcomes of applying IAS 32. In some cases, the current classification requirements in IAS 32 may be clear but questions exist about whether the resulting classification provides useful information. Evaluating the benefits of more useful information against the costs of implementation would be particularly important because such a decision would affect all entities that issue those relevant financial instruments.
- (d) clarify interactions between the requirements in IAS 32 and ensure the clarifying amendments do not create any internal inconsistencies in IAS 32. For example, the interactions can be clarified so that it is clear in what order the requirements should be applied and which requirement should apply to a particular financial instrument.
- (e) finalise the amendments in a timely manner—the staff think that timely finalisation should be an important consideration in identifying which matters to address as part of this project and in considering how to address them. For many of the identified practice issues, accounting diversity has persisted for a long period of time. As the project

- progresses, the Board could reassess whether a solution can be developed within a timeframe that would not significantly delay the finalisation of the other matters within the scope of the project. As a result of this reassessment, the Board may ultimately decide that a particular issue should not be addressed as part of this project; and
- (f) develop an efficient transition approach that will consider implementation costs.

### **Project plan—classification**

7. At the September 2019 Board meeting, to help ensure that the project proceeds in an efficient manner, the Board considered a set of criteria to identify the issues that should be within the project scope. The Board tentatively decided to address issues:
  - (a) that have a widespread effect and have, or are expected to have, a material effect on those affected;
  - (b) where financial reporting would be improved through a change in the required classification or through the elimination, or reduction, of diverse accounting outcomes that result from a lack of clarity in the IAS 32 requirements or insufficient application guidance; and
  - (c) that can be resolved efficiently and effectively without:
    - (i) fundamentally rewriting IAS 32; and
    - (ii) amending other IFRS Standards (except for consequential amendments).
8. The staff acknowledge that as the project progresses the Board will likely need to reassess whether a potential solution can resolve a particular issue efficiently and effectively as described in the third criterion in paragraph 7(c). For the time being, unless the staff has identified a clear reason why an issue does not meet that criterion, the staff would assume that the criterion is met. The staff plan to analyse whether a potential solution meets the third criterion as the staff further analyse potential solutions in future meetings.

9. Applying the criteria in paragraph 7 of this paper to application challenges highlighted through the feedback on the DP, the Board's previous consultations and submissions to the Committee, the staff have identified a number of practice issues that are likely to meet all three criteria and that the Board could address in the scope of the project. The preliminary list of such issues is as follows:
- (a) classification of financial instruments that will or may be settled in the issuer's own equity instruments, eg application of the fixed-for-fixed condition to particular derivatives on own equity and the classification of mandatorily convertible financial instruments;
  - (b) accounting for obligations to redeem own equity instruments, eg accounting for written put options on non-controlling interests (NCI puts).
  - (c) accounting for financial instruments that contain contingent settlement provisions, eg financial instruments with a non-viability clause.
  - (d) the effect of laws and regulations on the classification of financial instruments;
  - (e) reclassification between financial liability and equity instruments, eg when circumstances change, or contractual terms are modified; and
  - (f) classification of particular financial instruments that contain obligations that arise only on liquidation of the entity, eg perpetual financial instruments.<sup>1</sup>
10. The staff analyse below how each of the practice issues in paragraph 9 of this paper are deemed to meet the criteria set out in paragraph 7 of this paper. In line with the discussion in paragraph 8 of this paper, the staff provided examples to illustrate how the third criterion may be met.

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<sup>1</sup> The financial instruments described in this subparagraph do not include those that are subject to the specific exception in paragraphs 16C-16D of IAS 32, ie instruments, or components of 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.

***Financial instruments settled in own equity instruments****What is the problem?*

11. IAS 32 classifies a derivative as a financial asset or a financial liability if the derivative will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments (fixed-for-fixed condition). Various questions have arisen regarding the application of the fixed-for-fixed condition to derivatives on own equity— for example, how to apply the fixed-for-fixed condition to a written call option to deliver a fixed number of an entity's own shares in exchange for a fixed amount of cash when the number of shares changes only as a result of an anti-dilution provision. Many of these questions apply to both standalone derivative instruments and derivatives that are embedded in another instrument.
12. Practice questions in this area are not limited to derivatives on own equity. There are many non-derivative financial instruments that are settled in own equity instruments. IAS 32 requires an entity to classify a non-derivative financial instrument as a financial liability if the instrument obliges the entity to deliver a variable number of its own equity instruments. Practice questions exist on how some of these financial instruments should be classified applying IAS 32, for example some mandatorily convertible instruments.

*Is the issue widespread and has, or is expected to have, a material effect on those affected?*

13. Many companies in many jurisdictions issue derivatives on own equity, either as a standalone instrument and as a derivative embedded in another instrument such as a convertible bond. Many of these derivatives contain clauses such as anti-dilution or change in control provisions that may adjust the number of own equity instruments or the amount of cash or another financial asset to be exchanged.
14. Based on the feedback received on the 2018 DP and the Board's previous consultations, many respondents described the application of the fixed-for-fixed condition as one of the most significant sources of practice questions and accounting diversity.

*Would financial reporting be improved through a change in the required classification or through the elimination, or reduction, of diverse accounting outcomes?*

15. Evidence of accounting diversity on the application of the fixed-for-fixed condition is available in many forms. As well as the feedback on the DP, there have been a number of questions submitted to the Committee.
16. In 2009 and 2010, the Committee discussed questions relating to the application of the fixed-for-fixed condition. As noted in the Committee's agenda decision, the Committee identified that diversity may exist in practice in the application of the fixed-for-fixed condition, and the Committee decided not to add the issue to its agenda in view of the then on-going project on FICE. The feedback received on the DP confirmed that the application of the fixed-for-fixed condition continues to be an area of application challenges and accounting diversity.
17. The staff are of the view that reduction or elimination of accounting diversity will improve the usefulness of information provided in the financial statements because the financial reporting consequences of classifying a financial instrument as an equity instrument is significantly different from the consequences of being classified as a financial asset or financial liability.

*Can the issue be resolved efficiently and effectively without fundamentally rewriting IAS 32 and amending other IFRS Standards?*

18. In the staff's view, the Board would be able to address the issue efficiently and effectively without fundamentally rewriting IAS 32 by for example, exploring the following:
  - (a) add an explanation of the principle underlying the fixed-for-fixed condition in IAS 32, for example, by focusing on the position of the holder of a derivative on own equity relative to the holder of the underlying equity instruments;
  - (b) clarify the application of the principle to other financial instruments settled in own equity instruments, that is non-derivative instruments;and

- (c) supplement the principle by illustrative examples in the application guidance in IAS 32 to facilitate the consistent application.

19. If a derivative is classified as a derivative asset or a derivative liability or if a non-derivative financial instrument is classified as a financial liability applying IAS 32, then the recognition and measurement requirements in IFRS 9 apply. The staff do not envisage any changes to this linkage and do not suggest any changes to those IFRS 9 requirements.

### ***Obligations to redeem own equity instruments***

#### *What is the problem?*

20. Paragraph 23 of IAS 32 requires a contract that contains an obligation for an entity to purchase its own equity instruments for cash or another financial asset to be recognised as a financial liability. The financial liability is recognised initially at the present value of the redemption amount and is reclassified from equity. For example, a forward contract that obliges an entity to purchase its own equity instruments for cash or a written put option that gives the counterparty the right to sell an entity's own equity instruments to the entity for cash gives rise to a financial liability for the present value of the redemption amount. Several questions have arisen regarding the application of this requirement and in addition, some stakeholders have questioned whether the requirement is appropriate. In particular, the Committee and the Board discussed several issues related to obligations to redeem own equity instruments and NCI puts between 2006–2016, for example:

- (a) what is the debit entry to equity when the redemption amount is reclassified;
- (b) how to account for changes in the carrying amount of the financial liability;
- (c) how to account for NCI puts that will or may be settled by the delivery of a variable number of the parent's own equity instruments instead of cash or another financial asset; and



- (d) whether the parent should recognise a financial liability for the present value of the option's exercise price (on a gross basis) or a derivative liability (on a net basis).

*Is the issue widespread and has, or is expected to have, a material effect on those affected?*

21. Many companies in many jurisdictions issue contracts that contain an obligation to purchase own equity instruments. Entering into NCI puts is particularly common in many jurisdictions—the use of NCI puts is a common acquisition strategy for the buyer and a common exit strategy for the seller in a business combination. Previous Committee and Board consultations and discussions have confirmed that the amounts involved are material.

*Would financial reporting be improved through a change in the required classification or through the elimination, or reduction, of diverse accounting outcomes?*

22. Evidence of accounting diversity in the application of the requirements for obligations to redeem own equity instruments is available in many forms. As well as the feedback on the 2018 DP, there have been a number of questions submitted to the Committee that remain unresolved.
23. In 2006, the Committee discussed a request to clarify the accounting related to NCI puts (or NCI forwards) to be settled for cash. As part of its agenda decision, the Committee agreed that there is likely to be divergence in practice in how an entity reclassifies the related equity but did not believe it could reach a consensus on this matter on a timely basis.
24. In 2010, the Committee received a request regarding how a parent accounts for changes in the carrying amount of a financial liability for NCI puts to be settled *for cash* in the consolidated financial statements. The submission considered whether there was a potential conflict between IAS 27 *Consolidated and Separate Financial Statements* and IAS 39 *Financial Instruments: Recognition and Measurement* (which were applicable at the time of the Committee's discussion). The Committee published a tentative agenda decision that explained that IAS 32

requires an entity to subsequently measure the financial liability applying IAS 39 and that additional accounting concerns related to NCI puts would best be addressed as part of the then on-going FICE project. A significant number of comments on the Committee's tentative agenda decision highlighted significant diversity in practice in the accounting for NCI puts.

25. Consequently, in 2012, the Committee published a Draft IFRIC Interpretation *Put Options Written on Non-controlling Interests*, which explained the following:

- (a) an entity remeasures the financial liability recognised for an NCI put applying IAS 39 (IFRS 9), which requires the entity to recognise changes in measurement in profit or loss; and
- (b) the changes in measurement of that financial liability do not change the relative interests in the subsidiary held by the parent and the non-controlling-interest shareholder, and therefore are not equity transactions.

26. Many respondents to the draft Interpretation expressed the view that either the Committee or the Board should address the accounting for NCI puts—or all derivatives written on an entity's own equity—more comprehensively. Those respondents said that many aspects of the accounting for those contracts have resulted in diversity in practice. Consequently, at the January 2013 meeting, the Committee decided to ask the Board to reconsider the requirements in IAS 32 for put options and forward contracts written on an entity's own equity and noted that such work should consider whether an entity accounts for NCI puts and NCI forwards differently from other derivatives written on an entity's equity. In March 2013, the Board decided to reconsider the requirements in paragraph 23 of IAS 32 and at its October 2014 meeting, the Board discussed the scope of the FICE project and decided that it will consider derivatives that may or must result in buying back own equity as part of the FICE project, amongst other issues.

27. In 2016, the Committee received a request about the accounting in the consolidated financial statements when the NCI put will or may be settled by the delivery of a variable number of the parent's own equity instruments instead of cash or another financial asset. The Committee observed that, in the past, it had discussed issues relating to NCI puts that are settled in cash and noted that on the

basis of its previous discussion, the issue is too broad to address efficiently within the confines of existing IFRS Standards.

28. The staff are of the view that a reduction or elimination of accounting diversity will improve the usefulness of information provided in the financial statements because the financial reporting consequences are significantly different for example, in the case of:

- (a) derecognising the non-controlling interests versus debiting another component of equity when a financial liability is recognised for the present value of the redemption amount and that amount is reclassified from equity; and
- (b) recognising subsequent changes in the carrying amount of the financial liability in profit or loss or equity.

*Can the issue be resolved efficiently and effectively without fundamentally rewriting IAS 32 and amending other IFRS Standards?*

29. In the staff's view, the Board would be able to address the issue efficiently and effectively without fundamentally rewriting IAS 32 by for example, exploring the following:

- (a) adding an explanation of the principle in IAS 32 for recognising an obligation to redeem own equity instruments for cash (or another financial asset) as a gross financial liability;
- (b) clarifying the accounting within equity;
- (c) clarifying the presentation of income and expenses related to the subsequent measurement of the financial liability especially if the NCI is puttable at fair value.

30. Many respondents to the 2018 DP suggested the Board consider the interaction with IFRS 10 in the analysis of NCI puts when determining its approach, in particular whether the transaction with the non-controlling interest is a transaction among shareholders and what the consequences are of derecognising the non-controlling interest, for example whether a portion of the subsidiary's total comprehensive income should still be attributed to the non-controlling interests. Another area highlighted by respondents is the interaction with IFRS 3 *Business*

*Combinations*, in particular whether the NCI put is part of the business combination transaction and the resulting implication on the calculation of goodwill. A few respondents also commented on the interaction with IAS 33 *Earnings per Share* if the non-controlling interest is derecognised, in particular whether the shares are still considered outstanding for the purposes of computing earnings per share. These interactions may be relevant for the Board to consider when determining how to clarify IAS 32. The staff envisage that clarifications could be made to IAS 32 for some of the above issues with possible consequential, but not fundamental, changes to other IFRS Standards.

### ***Contingent settlement provisions***

#### *What is the problem?*

31. IAS 32 classifies a financial instrument as a financial liability if it requires the entity to deliver cash or another financial asset, or otherwise to settle the instrument in such a way that it would be a financial liability, in the event of the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder of the instrument (for example a change in a stock market index or the issuer's future revenues). Questions have arisen regarding the application of this requirement. For example, some respondents have asked for guidance on whether a particular contingently convertible financial instrument meets the definition of a financial liability in its entirety or whether it can be classified as a compound instrument if there are discretionary interest payments. Other questions include:
- (a) whether conditionality in settlement outcomes should be factored into the classification of the financial liability when the alternative settlement outcomes are contingent on an uncertain future event that is beyond the control of both the entity and the holder and how conditionality affects the measurement of the financial instrument;
  - (b) how to determine whether an event is within the entity's control for example, an event contingent on shareholders' approval;

- (c) how to account for discretionary interest payments if the entire proceeds are allocated to the liability component of a compound instrument.

*Is the issue widespread and has, or is expected to have, a material effect on those affected?*

32. Many companies in many jurisdictions issue contracts which contain contingent settlement provisions. After the 2008 global financial crisis and in recent years, there has also been an increase in the number of instruments issued with loss absorption features using a conversion mechanism—for example, an obligation for the issuer to convert the instrument into a variable number of own shares on the occurrence of a specified trigger event, for example, if the issuer’s Common Equity Tier 1 or solvency ratio falls below a certain threshold or if a relevant authority deems the issuer to be non-viable (collectively referred to as ‘contingent non-viability event’).

*Would financial reporting be improved through a change in the required classification or through the elimination, or reduction, of diverse accounting outcomes?*

33. There is evidence of accounting diversity in the application of the contingent settlement provision requirements. In addition to the feedback on the DP, there have been a number of questions submitted to the Interpretations Committee that remain unresolved.
34. In 2010, the Committee discussed a request for guidance on whether a financial instrument, in the form of a preference share that includes a contractual obligation to deliver cash, is a financial liability or equity, if the payment is at the ultimate discretion of the issuer’s shareholders. The Committee identified that diversity may exist in practice in assessing whether an entity has an unconditional right to avoid delivering cash if the contractual obligation is at the ultimate discretion of the issuer’s shareholders, and consequently whether a financial instrument should be classified as a financial liability or an equity instrument. The Committee recommended that the Board address this issue as part of its then on-going FICE project.

35. In 2014, the Committee discussed how an issuer would classify a particular financial instrument which did not have a stated maturity date but was mandatorily convertible into a variable number of the issuer's own equity instruments if the issuer breached the Tier 1 Capital ratio (the contingent non-viability event). Interest payments on the instrument are payable at the discretion of the issuer. Specifically, the Committee discussed the following issues:
- (a) whether the financial instrument meets the definition of a financial liability in its entirety or must be classified as a compound instrument comprised of a liability component and an equity component (and, in the latter case, what those components reflect); and
  - (b) how the financial liability (or liability component) identified in (a) would be measured.

The Committee noted that the scope of the issues raised in the submission were too broad for it to address in an efficient manner.

36. The staff are of the view that reduction or elimination of accounting diversity will improve the usefulness of information provided in the financial statements because the financial reporting consequences of equity classification are significantly different from the consequences of financial liability classification or compound instrument accounting. In addition, there are significantly different financial reporting consequences for the measurement of a financial liability depending on whether probability of repayment or expectations about timing of repayment are taken into account.

*Can the issue be resolved efficiently and effectively without fundamentally rewriting IAS 32 and amending other IFRS Standards?*

37. In the staff's view, the Board would be able to address the issue efficiently and effectively without fundamentally rewriting IAS 32 by for example, exploring the following:
- (a) adding an explanation of when the compound instrument guidance applies and clarifying the order of identifying components;
  - (b) clarifying whether and how conditionality should be considered in the classification and measurement of the financial instrument;

- (c) adding illustrative examples on when shareholders are acting as part of the entity or as investors;
  - (d) adding illustrative examples on which events can be seen to be within or outside the control of the entity.
38. If a financial instrument is classified as a financial liability or contains a financial liability component applying IAS 32, the recognition and measurement requirements in IFRS 9 are relevant. However, in the case of a financial instrument that could be required to be settled at a particular amount upon a contingent event occurring, there is a question on whether IAS 32 requires the entity to measure the financial liability for that full amount of the obligation.

### ***The effects of laws and regulations on the classification of financial instruments***

#### *What is the problem?*

39. The definition of a financial instrument in IAS 32, as well as the definitions of a financial asset, a financial liability and an equity instrument, refer to *contracts* and *contractual* rights or *contractual* obligations. In addition, paragraph 13 of IAS 32 states that:

In this Standard, 'contract' and 'contractual' refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing.

40. Applying IAS 32, assets and liabilities that are not contractual, for example rights and obligations that arise from statutory requirements imposed by government, are not financial liabilities or financial assets. Paragraph AG12 of IAS 32 states the following:

Liabilities or assets that are not contractual (such as income taxes that are created as a result of statutory requirements imposed by governments) are not financial liabilities or financial assets. Accounting for income taxes is dealt with in

IAS 12. Similarly, constructive obligations, as defined in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, do not arise from contracts and are not financial liabilities.

41. However, questions arise in practice about the effect of laws and regulations on the rights and obligations arising from a contract (including, but not limited to, their enforceability). More specifically, the question is whether classification of a contract as a financial liability or an equity instrument should be based solely on the contractual terms (that is, what is specified in the contract) or whether classification should also consider the laws and regulations in a particular jurisdiction that might affect the rights and obligations established in a contract.
42. One example is a bond that is contingently convertible into ordinary shares as a result of legal or regulatory requirements. Some have asked whether laws and regulations that impose contingent conversion features on particular types of claims issued by an entity should ever be considered in classifying such instruments as financial liabilities or equity instruments. One of the common practice questions is whether reproducing the relevant legal requirements in the contract makes them part of the contractual terms. A follow on question is whether it matters to the classification outcome if such a reference to legal requirements is dynamic (the reference is made in such a way that ensures the contract refers to the *currently effective* legal requirements should the legal requirements be amended in the future) or static (a simple reproduction of legal requirements that may become out of date if the legal requirements are amended).
43. Another question that has been raised by some stakeholders relates to statutory obligations to pay dividends on ordinary shares. The staff understand that in some jurisdictions, entities are required by law to distribute a specified percentage of their profits as dividends to ordinary shareholders. Some stakeholders have asked whether that statutory obligation to distribute profit ever gives rise to a financial liability, and if not, whether reproducing that statutory requirement in the contract would make it part of the contract and hence give rise to a contractual obligation that would meet the definition of a financial liability.
44. In both examples, entities may arrive at different classification outcomes for the same financial instruments depending on whether the effects of laws and



regulations are considered in classification or depending on how they incorporate reference to laws and regulations in the contractual terms.

*Would financial reporting be improved through a change in the required classification or through the elimination, or reduction, of diverse accounting outcomes?*

45. The Board was aware of challenges in this area when developing the 2018 DP. The feedback on the DP confirmed the Board's understanding. Many respondents highlighted practice challenges in this regard and requested clarification and additional guidance on these areas.
46. The staff are of the view that reduction or elimination of accounting diversity will improve the usefulness of information provided in the financial statements because legal requirements may modify or add to contractual obligations. A different classification outcome could result depending on whether or not the effects of laws and regulations are taken into account.

*Can the issue be resolved efficiently and effectively without fundamentally rewriting IAS 32 and amending other IFRS Standards?*

47. In the staff's view, the Board would be able to address the issue efficiently and effectively without fundamentally rewriting IAS 32 by for example, exploring the following:
- (a) clarifying whether reproducing particular legal requirements in the contractual terms make them part of the contractual terms; and
  - (b) supplementing the principle by using illustrative examples to facilitate consistent application.
48. However, it should be noted that some questions are by nature more difficult to resolve without fundamentally reconsidering the requirements in IAS 32. This is especially the case where there is no contract. For example, laws or regulations in some jurisdictions oblige some entities to offer to purchase the non-controlling interests when acquiring a controlling interest (mandatory tender offer). In the staff's view, amending IAS 32 in a way that it scopes in this type of obligation would require a fundamental rewrite of IAS 32. Therefore, the staff would expect this issue to be outside the scope of this project. Clarifications made as part of

this project could be relevant to the accounting for financial assets, which is based on contractual rights. The analysis in this project would therefore need to consider any relevant implications for IFRS 9.

## **Reclassification**

### *What is the problem?*

49. IAS 32 itself has limited guidance on reclassification between financial liabilities and equity instruments. Paragraphs 16E and 16F of IAS 32 discuss 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’). Paragraph 23 of IAS 32 discusses the reclassification upon expiry of a contract that contains an obligation for an entity to purchase its own equity instruments for cash or another financial asset; that is upon such expiry, the ‘grossed up liability’ is reclassified back to equity. IFRIC 2 *Members’ Shares in Co-operative Entities and Similar Instruments* discusses the transfer of amounts between equity and financial liabilities and IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments* provides requirements for when a financial liability is extinguished and equity instruments are issued.
50. Questions have arisen regarding reclassification between financial liabilities and equity instruments. 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. Two issues were discussed:
- (a) on what basis the financial liability should be measured at the date when the terms were changed and
  - (b) how any difference between the carrying amount of the previously recognised equity instrument and the amount of the financial liability recognised at the date when the terms were changed should be accounted for.
51. Respondents 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, taken as a whole, were sufficiently clear and that the issue was not expected to have widespread relevance in practice. It noted that at the time 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, at the time 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. Despite the agenda decision, a few respondents to the 2018 DP still said it is unclear whether the modification of a contract should require reclassification and how such modifications should be accounted for. The staff understands that this lack of clarity could arise in the case where there has been an amendment to the contractual terms which does not give rise to a derecognition event or in the case of modifications to the terms of compound instruments.

52. Other questions raised relate to reclassifications after initial recognition when circumstances change but the contractual terms have not changed for example, a change in functional currency, expiry of an option or an unrelated party becoming a subsidiary.

*Is the issue widespread and has, or is expected to have, a material effect on those affected?*

53. The staff understand that it is common for many companies in many jurisdictions to modify or amend the contractual terms of an instrument including in such a way that the classification outcome would be different from that initially assessed. In addition, as mentioned in paragraph 52 of this paper, circumstances could change even though the contractual terms have not changed. The feedback on the

2018 DP 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 contractual terms are unchanged, and if so, when.

*Would financial reporting be improved through a change in the required classification or through the elimination, or reduction, of diverse accounting outcomes?*

54. Whenever an accounting treatment is unclear in an IFRS Standard, there is a risk of the IFRS Standard being interpreted in different ways. Feedback on the 2018 DP implies that there may be diverse accounting outcomes when circumstances change without an amendment of contractual terms. For example, when reclassifying a financial liability to equity due to a change in circumstances when there has been no change in the contractual terms, the question arises as to whether an entity should analogise to:
- (a) the guidance in IFRIC 19— 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; or
  - (b) the guidance in 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.
55. The staff are of the view that reduction or elimination of accounting diversity caused by a lack of clarity in IAS 32 requirements will improve the usefulness of information provided in the financial statements. For example, the financial reporting consequences of recognising a gain or loss in profit or loss on subsequent reclassification of financial liabilities to equity instruments are very different to not recognising a gain or loss.

*Can the issue be resolved efficiently and effectively without fundamentally rewriting IAS 32 and amending other IFRS Standards?*

56. In the staff's view, the Board would be able to address the issue efficiently and effectively without fundamentally rewriting IAS 32 by for example, exploring the following:
- (a) considering whether the reclassification guidance in IAS 32 for puttable instruments and obligations arising on liquidation could be applied more broadly in developing principles for reclassification; and
  - (b) supplementing these principles with illustrative examples on reclassifications when the contractual terms are and are not modified to facilitate the consistent application of these principles.
57. As discussed in paragraph 49 of this paper, IFRIC 2 and IFRIC 19 contain some requirements that may be relevant to the discussion in this project on reclassifications. IFRS 9 sets out the requirements for reclassifying financial assets between measurement categories. The related requirements in these IFRS Standards could be considered in developing the principles on reclassification between financial liabilities and equity instruments but no changes to these other IFRS Standards are expected because for example, they relate to specific fact patterns or specific types of transactions.

### ***Obligations that only arises on liquidation of the entity***

*What is the problem?*

58. Some entities issue perpetual financial instruments that contain obligations for which an entity has an unconditional right to defer cash payment until liquidation. IAS 32 classifies such financial instruments as equity instruments because there is no contractual obligation to transfer cash or another financial asset or to deliver a variable number of shares at a specified time other than at liquidation.
59. In 2006, the Committee discussed a question on the role of economic compulsion in the classification of financial instruments. One of the examples provided in the submission was a financial instrument that does not contain a contractual obligation that meets the definition of a financial liability but grants a call option

to the issuer to redeem the instrument at a specified date and a “step-up” clause that resets interest on the instrument to a higher rate if the issuer does not redeem the instrument after a specified period. The issuer can be economically compelled to redeem the instrument to avoid a high cost of funding, particularly if the spread resulting from the step-up clause is significantly higher than the spread applicable to the issuer for equivalent instruments without a step-up clause.

60. Both the Committee and the Board discussed the issue. The Board confirmed that contractual obligations could be established explicitly or indirectly, but they must be established through the terms and conditions of the instruments. Thus, by itself, economic compulsion would not result in a financial instrument being classified as a liability under IAS 32. The Board also stressed that IAS 32 requires an assessment of the substance of the contractual arrangement, but it does not however require or permit factors not within the contractual arrangement to be taken into consideration in classifying a financial instrument. A summary of the Board discussion was included in the tentative agenda decision. However, comments received on the Committee’s tentative agenda decision highlighted a lack of clarity in the IAS 32 requirements in this area, for example to what extent the indirect obligation requirement applies. Some respondents expressed the views that it is unclear whether the contractual terms such as a step-up clause and the issuer’s call option establish an indirect obligation on the issuer to pay cash. In addition, questions were raised as to whether the classification outcome reflects the substance of the contractual arrangement. The Committee’s final agenda decision states that the Committee believed that it could not achieve anything substantial by adding the issue onto the agenda. Instead, the Committee agreed to draw the Board’s attention to comments raised by constituents and to ask the Board whether anything could be done to achieve even greater clarity on this point.

*Is the issue widespread and has, or is expected to have, a material effect on those affected?*

61. Outreach undertaken on the 2018 DP highlighted the prevalence in several jurisdictions of financial instruments that contain obligations that only arise on the liquidation of the entity. The staff understand that this type of financial instrument is issued by both financial institutions and corporates. While the features of these

financial instruments vary, the common characteristics they share are (i) the issuer's ability to defer cash payment until the liquidation of the issuer, which is the feature that achieves the equity classification applying IAS 32; and (ii) incentives for the issuer to make cash payments at specified date(s).<sup>2</sup>

*Would financial reporting be improved through a change in the required classification or through the elimination, or reduction, of diverse accounting outcomes?*

62. The staff are of the view that the learnings from the 2018 DP outreach and feedback provide adequate evidence that the Board should at least consider whether the current equity classification of these types of financial instruments provides useful information to users of the financial statements. Because these instruments tend to have standardised contractual terms, investors in these particular financial instruments said that they understand their economics and did not view the current classification (ie equity) as a problem. However, it is not evident whether investors in other classes of financial instruments, especially those that invest in ordinary shares of companies, share this understanding. Some equity investors indicated that they consider this type of financial instruments to be financial liabilities for the purposes of their own analysis.
63. These financial instruments are designed to behave like a financial liability (ie pay interest based on a specific coupon rate and are repaid at a specified date even though there is no obligation to do so) when the issuer is performing. They are designed to provide some flexibility if the issuer experiences financial difficulties by allowing the issuer to defer the interest and/or the principal repayments.<sup>3</sup> Contractually speaking, the issuer can defer such payments until liquidation. The staff understand that fixed income investors purchase these instruments and in some jurisdictions the instruments are priced with an expectation that the issuer will redeem them at a specified number of years after the issuance. Rating

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<sup>2</sup> The issuer's incentives may be driven by a range of factors such as an immediate increase in the funding cost in the case of a 'step-up' financial instruments and a negative effect on the issuer's future ability to raise funding.

<sup>3</sup> Being a perpetual instrument, this type of financial instrument would not have a contractual maturity. The principal repayment will be 'deferred' from its 'expected' repayment date if the issuer does not choose to exercise the call option to redeem the financial instrument.

agencies do not usually treat this type of instruments as equity (but rather often treat them as 50% debt and 50% equity). Interest on such financial instruments is tax deductible in many jurisdictions, as interest on a straightforward debt would be. In the case of instruments issued by financial institutions, depending on their loss absorbing characteristics, some of these instruments would be eligible for classification as Additional Tier 1 capital.

*Can the issue be resolved efficiently and effectively without fundamentally rewriting IAS 32 and amending other IFRS Standards?*

64. The staff recommend that the Board explore whether the Board needs to address the issue and if so whether it can be resolved efficiently and effectively without fundamentally rewriting IAS 32 by for example:
- (a) understanding the information needs of the investors, especially those that invest in ordinary shares of companies; and
  - (b) evaluating the costs and benefits of a potential classification change.

### **Project plan—presentation and disclosure**

65. The staff are of the view that the Board’s starting point for clarifying presentation and disclosure should be the proposals in the 2018 DP. Those proposals would be further developed or modified taking into account the feedback received.
66. The staff plan to undertake further research and outreach to address questions that arose under each of the three types of disclosures as follows:
- (a) priority on liquidation—consider possible simplification and operational aspects especially for group entities;
  - (b) potential dilution of ordinary shares—consider the scope such as whether the disclosure should be required for listed entities only and whether the disclosure should include instruments to which IFRS 2 *Share-based Payment* applies; and
  - (c) terms and conditions of financial instruments that may affect the timing or the amount of cash flows of the financial instruments—consider how to avoid the ‘disclosure overload’ problem.



67. In addition, the staff recommend that the Board explore further developing some of the proposals included in the presentation section of the 2018 DP. The 2018 DP proposed using additional line items on the face of the financial statements, for example, disaggregation of dividends paid to ordinary shareholders and those paid to other non-derivative equity holders. That proposal attracted some support from stakeholders including users of the financial statements.
68. Finally, the staff recommend that the Board explore whether any additional disclosure requirements should be developed to provide information that would not be provided through classification requirements or to complement the classification requirements. Taking into account that the need for additional disclosures will have a close interaction with the Board's decisions on classification, the staff will continue to assess the need for additional disclosures as the project progresses. At this stage, based on feedback received on the 2018 DP, the staff consider the following as examples of potentially useful disclosures in addition to those described in paragraphs 66 of this paper:<sup>4</sup>
- (a) description of contractual terms that may be influenced by economic incentives of the entity so users can better understand the expected outcomes;
  - (b) description of possible settlement outcomes for financial instruments that have alternative settlement outcomes that are controlled by the issuer;
  - (c) whether and how laws and regulations can affect settlement outcomes; and
  - (d) trigger events for which the occurrence would have changed the instrument's classification if classified at that date, for example, the expiry of an option that allows the holder to put the financial instrument back to the issuer for cash.

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<sup>4</sup> Some of these disclosures may form part of the terms and conditions disclosure proposal.

## Indicative project timeline

69. The following table illustrates the order in which the staff expect to bring the analyses of issues to the Board for its deliberations. Also included below is an indication of the expected commencement of the Board deliberations on each issue. For example, the staff are aiming to bring an analysis on the fixed-for-fixed condition in Q4 2019 so that the Board can start deliberating the issue. The staff expect the Board’s discussion on that topic to continue through to Q1 or Q2 of 2020. The staff envisage that because there will be interactions amongst the classification topics and between the classification and presentation/disclosure topics, there may be a need to assess some of the decisions made in one area in light of the decisions made in another area as the project progresses.

<b>Classification</b>	<b>Presentation and disclosure</b>	<b>Indicative commencement</b>
<ul style="list-style-type: none"> <li>• Financial instruments settled in own equity instruments (including fixed-for-fixed condition)</li> </ul>	<ul style="list-style-type: none"> <li>• Research and outreach</li> </ul>	Q4 2019
<ul style="list-style-type: none"> <li>• Contingent settlement provisions</li> <li>• Effects of laws and regulation</li> </ul>	<ul style="list-style-type: none"> <li>• Further development of the disclosure proposals in the 2018 DP</li> </ul>	H1 2020

<ul style="list-style-type: none"> <li>• Obligations that only arise on liquidation (eg perpetual instruments)</li> <li>• Obligations to redeem own equity instruments (including NCI puts)</li> </ul>	<ul style="list-style-type: none"> <li>• Development of any further disclosure requirements</li> <li>• Further development of particular presentation proposals in the 2018 DP</li> </ul>	<p>H2 2020</p>
<ul style="list-style-type: none"> <li>• Reclassification and any other issues</li> <li>• Overall consistency check and evaluation of classification principles</li> <li>• Disclosure circle-back based on assessment as to whether any additions or modifications to disclosure proposals are necessary in light of the classification decisions made</li> </ul>		<p>H1 2021</p>

**Question for the Board**

70. The staff would like to ask the Board the following question.

**Question for the Board**

Do Board members have any comments or questions on the project plan and indicative project timeline set out in this paper?