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STAFF PAPER

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Project	Financial Instruments with Characteristics of Equity (FICE)
Paper topic	Obligations that only arise on liquidation of the entity—Potential solutions

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Introduction

1. Following on from the discussion on financial instruments with obligations that only arise on liquidation of the entity in Agenda Paper 5E, in this paper, the staff set out the following:

   (a) potential classification solutions (paragraphs 2–4);

   (b) potential presentation and disclosure solutions (paragraphs 5–17);

   (c) staff's preliminary view (paragraph 18–23); and

   (d) question for the Board (paragraph 24).

Potential classification solutions

2. If the Board wishes to explore a classification change for these types of financial instruments, the staff identified the following potential ways to do so:

(a) introduce a notion that is similar to the amount feature that was explored in the 2018 DP. Under this approach, a financial instrument that contains an unavoidable contractual obligation to transfer a fixed or determinable amount of cash or another financial asset which does not vary with net assets of the entity would be classified as a financial liability even if that contractual obligation only arises on liquidation of the entity. Such an obligation does not represent a residual interest in the entity at any time (including at liquidation of the entity) and therefore could be argued as inconsistent with the definition of an equity instrument; or

(b) expand the principle in paragraph 18 of IAS 32 that explains substance over legal form using instruments that combine features associated with equity instruments and features associated with financial liabilities. The principle could explain that financial liability classification would be more appropriate where these types of instruments, in substance behave like financial liabilities while the entity is a going concern. An example could be added that this would be the case for instruments that are generally redeemed at the first call date and have coupons that are generally paid regularly even though there is no contractual obligation to pay coupons and/or principal until liquidation; or

(c) expand the principle underlying the indirect obligation requirements in paragraph 20 of IAS 32. The principle can be demonstrated using the example of some perpetual instruments such as those that include a step-up clause. In these cases, although the entity does not have an explicit contractual obligation to deliver cash or another financial asset to settle the instrument, the value of the 'stepped coupon alternative' could be so economically disadvantageous that the entity will settle in cash. For example, the increased coupon required to be paid for choosing not to redeem the instrument at a given date could be so onerous that the entity would already know at inception that it would rather choose to redeem in cash. This approach would likely address only some types of perpetual instruments that contain contractual incentives for the issuer to transfer cash such as a step-up clause.

3. Unlike some of the issues the Board is considering as part of this project, the classification requirement in IAS 32 is clear in regard to these types of instruments. Hence, the Board's work in this area would constitute a change in the classification requirements and involve adding new principles as opposed to clarifying underlying principles in IAS 32.

4. If the Board were to pursue such a classification change, the concerns raised about the potential impact of 'legacy' instruments on an entity's financial position could be alleviated through specific transition provisions.

Potential presentation and disclosure solutions

5. Another alternative the Board could consider would be to address the information needs of users of financial statements through improved presentation and disclosure requirements. The staff set out possible solutions in the paragraphs below.

Separate presentation in the statement of financial position and statement of changes in equity

6. We understand that it is often difficult to identify the amounts related to these types of instruments in practice and as highlighted in Agenda Paper 5E, presentation in the statement of financial position and statement of changes in equity varies across entities and between banks and corporates.

7. Users of financial statements emphasised that clear visibility and transparency about these types of financial instruments is important to them. These types of financial instruments often behave differently and may participate in the returns of an entity differently from the more traditional equity instruments such as ordinary shares. As a result, users of financial statements would value a solution that would enable them to easily identify the existence of these types of financial instruments, ideally without having to go through multiple notes to the financial statements to try and piece together the information.

8. The staff are of the view that this can be achieved by requiring entities that issue these types of financial instruments to present them as a separate line item within equity, in the statement of financial position and in a separate column in the

statement of changes in equity. Separate presentation of coupons/dividends on these financial instruments would be similar to the 2018 DP proposals for non-derivative equity instruments. While most respondents did not agree with the 2018 DP's presentation proposals for derivative equity instruments, some, including users of financial statements, supported presentation proposals for non-derivative instruments.

9. In addition, the Board could explore presenting a section at the end the income statement which sets out the attribution of profit or loss to various equity instrument holders. The staff note that as part of the Primary Financial Statements Project, the Board is proposing requirements for presentation and disclosure in financial statements, with a focus on the statement of profit or loss. The Board undertook this project in response to investors' concerns about the comparability and transparency of companies' performance reporting. The staff will consider the developments on that project as the Board redeliberates proposals in the Exposure Draft *General Presentation and Disclosures* when we develop our proposals.

10. The scope of such a presentation requirement would at this stage be limited to financial instruments that contain obligations that only arise on liquidation of the entity that are classified as equity. However, the Board could consider expanding the scope to other types of non-derivative equity instruments when it discusses the presentation proposals under FICE at a future meeting.

11. The staff present below a simplified example of the separate presentation for these types of financial instruments in the consolidated statement of changes in equity. For the purposes of the example, we have assumed the following:

    (a) cumulative coupons for the period are CU15. Out of the CU15:

        (i) coupons paid during the period are CU5; and

        (ii) coupons accrued but unpaid during the period are CU10;

    (b) perpetual instruments of CU150 were issued during the period.

    (c) perpetual instruments of CU100 were redeemed during the period.

12. The profit attributable to perpetual instrument holders for the period would therefore show the sum of the contractual coupons paid and the coupons accrued but not yet paid (assuming the coupons are cumulative) to the holders during the

reporting period, ie CU15 in this example. Coupons paid during the reporting period would be shown as a deduction from equity attributable to perpetual instrument holders, ie CU5 in this example. The new column is presented within a red box.

Statement of changes in equity for the year ended at 31 December 2020 (in CU million)

	Share capital	Share premium	Retained earnings	Other reserves	Equity attributable to ordinary shareholders	Equity attributable to perpetual instrument holders	Non controlling interest	Total equity
Opening balance	900	1,100	19,930	495	22,425	200	335	22,960
Profit for the year			95		95	15	19	129
Other comprehensive income for the year				5	5		1	6
Total comprehensive income for the year			**95**	**5**	**100**	**15**	**20**	**135**
					0			0
Transactions with ordinary shareholders					0			0
Issuance of ordinary shares	100	100			200			200
Dividends distribution			(25)		(25)		(5)	(30)
								0
Transactions with perpetual instrument holders								0
Issuance of perpetual instruments						150		150
Redemption of perpetual instruments						(100)		(100)
Coupon paid on perpetual instruments						(5)		(5)
								0
Closing balance	**1,000**	**1,200**	**20,000**	**500**	**22,700**	**260**	**350**	**23,310**

13. The following shows a simplified illustration of separate presentation on the statement of financial position and at the end of income statement. New line items are presented within a red box.

Statement of financial position as at 31 December 2020 (in CU million)

	2020
Equity	
Called up share-capital	1,000
Share premium	1,200
Retained earnings	20,000
Other reserves	500
Equity attributable to ordinary shareholders of the parent	22,700
Perpetual instruments	260
Non-controlling interest	350
Total equity	23,310

Income statement for the year ended at 31 December 2020 (in CU million)

	2020
Total comprehensive income for the year	135
Attributable to:	
Ordinary shareholders of the parent	100
Holders of perpetual instruments	15
Non-controlling interest	20
Total comprehensive income for the year	**135**

Disclosure of terms and conditions

14. The 2018 DP proposed, amongst others, disclosure of key terms and conditions that affect the timing or amount of cash flows of the financial instruments. Considering that stakeholders broadly supported the proposal, the Board intends to further develop these disclosure requirements (see Agenda Paper 5D of this meeting).

15. Building on the proposal in the 2018 DP, the Board could consider developing more specific disclosure requirements for terms and conditions of these types of

financial instruments. For example, the Board could require entities to disclose key terms and conditions including the key features that lead to the equity classification and if applicable, any voting rights. As some of this information may already be provided by regulated entities such as banks either publicly or to their regulators, such a requirement would require less effort or costs for some preparers than having to provide the information from scratch. Furthermore, consistent with the requirements in IFRS 7 with regards to information that is already presented elsewhere, the information could be provided by cross-reference from the financial statements to other statements that are available to users of the financial statements on the same terms and at the same time as the financial statements[1].

16. For example, the following disclosure could be provided for the types of financial instruments discussed in this agenda paper.

Company X issues a perpetual bond. Key terms and conditions that affect its cash flows are as follows:

Nature	Timing	Amount	Uncertainty
Coupon	Semi-annually	5% per annum	Company X may defer interest payment at its discretion. Any deferred amounts accumulate and are added to the amount payable at the earlier of the redemption of the instrument or at the liquidation of Company X.
Principal repayment	Contractually due at the liquidation of Company A	Par value of £1 million if paid at liquidation of the entity	Company X holds a call option that can be exercised at the fifth anniversary after the issuance of the instrument. If called, the instrument is redeemable at 101% of the par value plus any unpaid and accumulated interest.

The perpetual bond carries no rights of conversion into ordinary shares of Company X and no right to attend or vote at shareholder meetings of Company X.

The perpetual bond is classified as an equity instrument because the issuer has no contractual obligation to deliver cash or another financial asset in any circumstances outside its control, except in the event of the liquidation of Company X.

17. For companies that have multiple issuances of perpetual financial instruments that contains obligations that only arise on liquidation, a summary for some of the

[1] Refer to paragraphs 21B and 35C of IFRS 7

terms could be provided using a tabular format so that it is easier for users of financial statements to understand. For example, the following table may be used to disclose some of the key terms and conditions of the instruments.

> At 31 December 2020, the total perpetual subordinated bonds outstanding amounted to CU4,750 million (less net-of-tax transaction costs) and are included in the Group equity. The table below includes the key terms of these financial instruments. Interest paid by the Group to the holders of perpetual subordinated bonds issued totalled CU255 million in 2020 and CU260 million in 2019. The resulting cash pay-out is reflected in a corresponding reduction in Group equity.

Entity	Issue	Nominal amount (millions of currency)	Currency	Redemption option	Coupon
Company P	Jan 2015	1,000	USD	10 years	5.5%
Company S	Mar 2016	750	EUR	12 years	4.5%
Company P	Oct 2017	2,000	EUR	6 years	4%
Company P	Jan 2019	1,000	GBP	8 years	3%

Staff's preliminary view

18. When considering the objective of this project in October 2019 (Agenda Paper 5), the Board tentatively decided to limit changes to required classification outcomes to those instruments for which there is clear evidence that a different classification would provide more useful information to users of financial statements compared to the current classification. Changes to classification outcomes may either result from addressing accounting diversity or from reconsidering the current classification outcomes of applying IAS 32. There does not appear to be any diversity in classification of instruments with obligations that only arise on liquidation. That is, when applying the requirements in IAS 32, it is clear that such obligations are required to be classified as equity (subject to there being no other terms that result in liability classification). Therefore, assessing whether a different classification would provide more useful information requires an understanding of the information needs of users of financial statements and an analysis of the costs and benefits of such a change (see paragraphs 40–47 of Agenda Paper 5E).

19. Feedback on the 2018 DP revealed that users of financial statements often reach their own conclusions about these classifications regardless of the entity's

classification in the financial statements. Respondents to the DP also commented that a change in accounting classification might be interpreted as a deterioration in the financial position of an entity (when in fact it remains unchanged) and therefore adversely affect the perceived market value of the entity. Debt analysts and investors in perpetual financial instruments with fixed cumulative returns were particularly concerned about a change in classification of these instruments and the potential market disruption if accounting call options are exercised.

20. As summarised in paragraphs 22–27 of Agenda Paper 5E, our additional outreach with equity analysts indicated that most of them treat these types of financial instruments as debt for the purpose of their analyses and that they would therefore prefer liability classification in the financial statements. Many of them, however, acknowledged that these financial instruments are different from vanilla financial liabilities and do have equity-like features. As a compromise, these equity analysts said that if equity classification is retained, separate presentation of these instruments and additional disclosure in the notes would be useful.

21. The staff note that more recently, there have been instances where perpetual instruments have not been called, regardless of whether there was a market expectation to do so. In 2019, a European bank surprised the market by not repaying an AT1 instrument on its first call date. In 2020, a number of banks did not call their AT1s/perpetual subordinated bonds on the first call date in the context of the covid-19 pandemic. For two such non-call events, the staff did research to assess whether the bond price or the share price of the bank were noticeably affected by the announcement not to call the bonds. As no significant movements were observed in either the bond price or corresponding share price following the announcements, it indicates that investors might have been expecting the banks not to call those bonds. In addition, in times of recession, the extension risk (ie not redeemed at the first call date) on corporate hybrids also increases.

22. Based on the feedback received from stakeholders and the findings from our research, the staff are of the view that the information needs of users of financial statements could be met by supplementing the existing IAS 32 classification requirements with new presentation and disclosure requirements as described in paragraphs 5–17 of this paper.

23. On balance, the staff's preliminary view is that the Board should consider developing presentation and disclosure requirements instead of changing the classification requirements. If the Board agrees, the staff will further develop potential presentation and disclosure requirements and present them at a future meeting.

Question for the Board

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

Question for the Board
Does the Board agree with the staff's preliminary view that it should consider developing presentation and disclosure requirements instead of changing the classification requirements for instruments that contain obligations that only arise on liquidation?