Need to know

IASB publishes Exposure Draft *Financial Instruments with Characteristics of Equity*

Contents

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This *Need to know* outlines the proposed amendments to IAS 32 *Financial Instruments: Presentation,* IFRS 7 *Financial Instruments: Disclosures* and IAS 1 *Presentation of Financial Statements* set out in Exposure Draft (ED) *Financial Instruments with Characteristics of Equity*, published by the International Accounting Standards Board (IASB) in November 2023.

- The IASB proposes amendments to IAS 32, IFRS 7 and IAS 1 to address challenges that arise from the classification of financial instruments by clarifying the principles in IAS 32 and to enhance presentation and disclosure requirements.
- In particular, the IASB proposes amendments to IAS 32 to clarify:
  - the effects of relevant laws or regulations (such as statutory or regulatory requirements applicable to a financial instrument) on the classification of financial instruments;
  - the 'fixed-for-fixed' condition for classifying a derivative that will or may be settled in an issuer's own equity instruments;
  - the requirements for classifying financial instruments containing an obligation for an entity to purchase its own equity instruments;
  - the requirements for classifying financial instruments with contingent settlement provisions;
  - the effect of shareholder discretion on the classification of financial instruments; and
  - the circumstances in which a financial instrument (or a component of it) is reclassified as a financial liability or an equity instrument after initial recognition.
- The IASB also proposes amendments to IFRS 7 and IAS 1 to enhance the disclosure and presentation requirements with regard to financial instruments issued by the entity.
- The ED does not specify an effective date for the amendments. Entities would be requiredto apply the amendments retrospectively. However, the IASB proposes not to require the restatement of information for more than one comparative period.
- The comment period for the ED ends on 29 March 2024.

Background

Since IAS 32 was published, financial innovation, market forces and changes to financial sector regulations have resulted in an increasing number of complex financial instruments with both financial liability and equity characteristics. This situation is challenging for entities applying IAS 32 and has resulted in diversity in practice regarding the classification of such instruments, which reduces the comparability and understandability of financial statements. This in turn makes it difficult for users of financial statements to assess the effects of financial instruments on the issuer's financial position and performance.

After considering feedback received in response to the Discussion Paper (DP) *Financial Instruments with Characteristics of Equity*, published in June 2018, the IASB decided not to pursue the classification approach proposed in the DP. Instead, the IASB decided to focus on clarifying the classification requirements in IAS 32, including their underlying principles, to address known practice issues that arise in applying IAS 32. The IASB also proposes to enhance the disclosure requirements in IFRS 7 related to financial instruments issued by an entity, and the presentation of amounts attributable to ordinary shareholders in IAS 1.

The proposed amendments

The effects of relevant laws or regulations

The definitions of a financial asset and a financial liability in IAS 32 refer to contractual rights and contractual obligations. However, issues arise in practice about whether and how laws or regulations (such as statutory or regulatory requirements) applicable to a financial instrument affect the classification of the instrument.

The IASB proposes to clarify that only those contractual rights and obligations that are enforceable by law and are in addition to those created by relevant laws or regulations are considered in the classification of a financial instrument (or its component parts) as a financial liability, financial asset or equity instrument. If a right or obligation arises from the relevant laws or regulations and would apply regardless of whether it is included in the contractual arrangement, an entity would not consider that right or obligation in classifying the instrument (or its components) as a financial liability, financial asset or equity instrument.

Settlement in an entity's own equity instruments

To be classified as an equity instrument, a derivative must be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of the issuer's own equity instruments, as required by IAS 32. This requirement is sometimes referred to as the 'fixed-for-fixed' condition. Practice issues arise about whether—to meet the fixed-for-fixed condition—any variation in the amount of consideration to be exchanged, or in the number of an entity's own equity instruments to be delivered, is permitted.

The IASB proposes to clarify the circumstances in which the fixed-for-fixed condition in IAS 32 is met. In particular, it proposes to specify that the amount of consideration to be exchanged for each of an entity's own equity instruments is required to be denominated in the entity's functional currency. In addition, the consideration would be required to be either:

- fixed (i.e. it does not vary under any circumstances); or
- variable solely because of:
  - preservation adjustments that require the entity to preserve the relative economic interests of future shareholders to an equal or lesser extent than those of current shareholders; and/or
  - passage-of-time adjustments that:
    - are predetermined;
    - vary with the passage of time only; 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.

Observation

The IASB considered various approaches in determining which passage-of-time adjustments would be consistent with the fixed-for-fixed condition, including requiring:

- the amount of consideration to be paid or received for each of an entity's own equity instruments on each possible settlement date to be predetermined at inception of the contract, to vary only with the passage of time and to be reasonable; or
- simply for the adjustment to be reasonable (without requiring that the adjustment be predetermined at inception of the contract or to vary only with the passage of time).

The IASB decided not to propose these approaches because both approaches would require an entity to exercise judgement to determine if an adjustment is reasonable. The IASB was of the view that, even if application guidance were developed to assist entities in making that judgement, it would be difficult to achieve consistent application of the requirements because such an adjustment could be very subjective in practice.

The IASB also proposes to clarify the accounting treatment for a derivative that gives one party a choice of settlement between two or more classes of an entity's own equity instruments. In such cases, the entity would consider whether the fixed-for-fixed condition is met for each class of its own equity instruments that may be delivered on settlement. Such a derivative would be an equity instrument only if all the settlement alternatives meet the fixed-for-fixed condition.

The IASB further proposes to clarify that a contract that will or may be settled by the exchange of a fixed number of one class of an entity's own non-derivative equity instruments for a fixed number of another class of its own non-derivative equity instruments is an equity instrument.

The ED proposes illustrative examples on applying the fixed-for-fixed condition.

Obligations to purchase an entity's own equity instruments

IAS 32 sets out requirements for contracts containing an obligation for an entity to purchase its own equity instruments. These include forward contracts to purchase the entity's own shares and written put options that give the holder the right to require the entity to purchase its own shares.

To address practice issues that arise from these requirements, the IASB proposes to clarify that:

- These requirements do not apply only to contractual obligations that will be settled in cash or another financial asset. They apply also to contracts that will be settled by delivering a variable number of another class of the entity's own equity instruments.
- If on initial recognition of the obligation to purchase its own equity instrument the entity does not yet have access to the rights and returns associated with ownership of the underlying equity instruments, those equity instruments continue to be recognised. Accordingly, the initial amount of the financial liability is not recognised with a corresponding debit to non-controlling interests or issued share capital. Instead, the initial amount of the financial liability is removed from another component of equity.
- An entity is required to use the same approach for initial and subsequent measurement of the financial liability (i.e. measure the liability at the present value of the redemption amount and ignore the probability and estimated timing of the counterparty exercising that redemption right).
- Any gains or losses on remeasurement of the financial liability are recognised in profit or loss.
- If the contract expires without delivery:
  - the carrying amount of the financial liability would be removed from financial liabilities and included in the same component of equity as that from which it was removed on initial recognition of the financial liability; and
  - any gains or losses previously recognised from remeasuring the financial liability would not be reversed in profit or loss. However, the entity may transfer the cumulative amount of those gains or losses from retained earnings to another component of equity.
- Written put options and forward purchase contracts on an entity's own equity instruments that are gross physically settled (i.e. there is an exchange of consideration for these own equity instruments) are required to be presented on a gross basis.

Observation

Over the years, several questions have been addressed to the IFRS Interpretations Committee on the application of IAS 32 related to written put options and forward purchase contracts on an entity's own equity instruments that are gross physically settled. Concerns were also raised in regard to the appropriate gross presentation for such contracts in responses to the DP.

However, the IASB remains of the view that recognising a financial liability for the gross amount of the consideration payable on settlement of the obligation helps users assess the entity's exposure to liquidity risk. Accordingly, the IASB does not propose a change to this requirement.

One of the IASB members voted against the publication of the ED because he disagrees with that decision. He also disagrees with the proposed requirement that the offsetting debit for contracts to purchase ownership interests of a subsidiary would be recognised within the ownership interests of the equity holders of the parent instead of against non-controlling interests.

Contingent settlement provisions

Financial instruments may include contingent settlement provisions, for example an instrument may require settlement in cash only upon the occurrence of an uncertain future event beyond the control of both the issuer and the holder of the instrument. The IASB proposes to clarify the requirements on how such instruments are classified applying IAS 32.

In particular, the IASB proposes to clarify that:

- The requirement in IAS 32:28 to assess whether a financial instrument contains both a liability and an equity component applies also to financial instruments with contingent settlement provisions. Therefore, such instruments may be compound financial instruments with liability and equity components (rather than financial liabilities in their entirety).
- The initial and subsequent measurement of the financial liability (or liability component of a compound financial instrument) arising from a contingent settlement provision does not take into account the probability and estimated timing of occurrence or non-occurrence of the contingent event.
- Payments at the issuer's discretion are recognised in equity even if the equity component of a compound financial instrument has an initial carrying amount of zero.
- The term 'liquidation' refers to the process that begins after an entity has permanently ceased its operations.
- The assessment of whether a contractual term is 'not genuine' requires judgement based on the specific facts and circumstances and is not based solely on the probability or likelihood of the contingent event occurring.

Shareholder discretion

When an entity applies IAS 32 to classify a financial instrument as a financial liability or an equity instrument, it considers whether it has an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation. In some cases, the settlement is at the discretion of the entity's shareholders. For example, an entity might issue preference shares that require the entity to pay coupons, which are subject to the approval of ordinary shareholders. In such cases, questions arise in practice about whether to treat a shareholder decision as an entity decision and how shareholder decision-making rights affect whether the entity has an unconditional right to avoid delivering cash or another financial asset (or to settle the instrument in such a way that it would be a financial liability).

To address these issues, the IASB proposes to:

- Clarify that whether an entity has an unconditional right to avoid delivering cash or another financial asset (or otherwise to settle a financial instrument in such a way that it would be a financial liability) depends on the facts and circumstances in which shareholder discretion arises. Judgement is required to assess whether shareholder decisions are treated as entity decisions.
- Describe the factors an entity is required to consider in making that assessment, namely whether:
  - The shareholder decision is routine in nature, made in the ordinary course of the entity's business activities: a routine decision is more likely to be treated as entity decision.
  - The shareholder decision relates to an action proposed or a transaction initiated by management: if an outflow of cash can be avoided by management not proposing an action, shareholder discretion would not affect the classification. However, if the shareholder decision relates to an action initiated by a third party, the shareholder decision is unlikely to be treated as an entity decision.

- Different classes of shareholders benefit differently from a shareholder decision: if each class of shareholder is likely to make an independent decision as investor of a specific class of shares, the shareholder decision is unlikely to be treated as an entity decision.
- Exercising a shareholder decision-making right enables a shareholder to require the entity to redeem (or pay a return on) its shares in cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability): such decision-making rights indicate that the shareholders would make their individual decisions as investors and the shareholder decision is unlikely to be treated as an entity decision.

Observation

In considering how shareholder discretion may affect classification of a financial instrument, the IASB noted contrasting views, with some stakeholders considering that shareholders are part of the entity (and shareholder decisions should be treated as the entity's decisions) and other stakeholders considering that shareholders are distinct from the entity (and shareholder decisions should never be treated as the entity's decisions).

The IASB concluded that applying such an "all or nothing" approach to classification of financial instruments would represent a fundamental change in accounting that would be beyond the scope of its project. Instead, the IASB decided to propose a list of factors that an entity would consider in assessing whether a shareholder decision is treated as an entity decision.

Reclassification of financial liabilities and equity instruments

IAS 32 requires the issuer of a financial instrument to classify the instrument on initial recognition as a financial liability or an equity instrument, based on the substance of the contractual arrangement and the definitions of a financial liability and an equity instrument.

However, the Standard does not contain any general requirements on whether or when to reclassify the instrument after initial recognition and if so, how to account for those reclassifications.

In practice, issues on whether a financial instrument should be reclassified arise mainly if the substance of the contractual arrangement changes without a modification to its contractual terms. This may be the case because of a change in circumstances external to the contractual arrangement—for example, a change in an entity's functional currency or its group structure.

To address the issues, the IASB proposes:

- to add a general requirement that prohibits the reclassification of a financial instrument after initial recognition, unless IAS 32:16E applies (this is the paragraph which addresses the reclassification of puttable instruments and instruments that impose an obligation to deliver a pro rata share of net assets of the entity only on liquidation) or the substance of the contractual arrangement changes because of a change in circumstances external to the contractual arrangement;
- to specify that if the substance of the contractual arrangement changes because of a change in circumstances external to the contractual arrangement, an entity would:
  - reclassify the instrument prospectively from the date when that change in circumstances occurred;
  - measure a financial liability reclassified from equity at the fair value of that financial liability at the date of reclassification. Any difference between the carrying amount of the equity instrument and the fair value of the financial liability at the date of reclassification would be recognised in equity; and
  - measure an equity instrument reclassified from a financial liability at the carrying amount of the financial liability at the date of reclassification. No gain or loss would be recognised on reclassification; and
- provide examples of changes in circumstances external to the contractual arrangement requiring reclassification.

Observation

The IASB considered alternatives to the proposed date on which a financial instrument would be reclassified as a financial liability or an equity instrument. For example, the IASB considered to require reclassification of the instrument only at the end of the reporting period in which the change in circumstances occurs. This would be the simplest and least costly for entities to apply.

However, if such an approach were applied, the timing of reclassification would depend on the reporting frequency. In addition, the approach would be inconsistent with the existing reclassification requirements in IAS 32, which apply to puttable financial instruments and instruments that impose an obligation on the entity to deliver to another party a pro rata share of the net assets of the entity only on liquidation, if those instruments meet specified criteria. IAS 32 requires that such instruments are reclassified from the date when the instrument meets (or ceases to meet) the specified criteria for classification as an equity instrument.

Therefore, the IASB decided that the date of change in circumstances is the most appropriate date for reclassification of an instrument.

Disclosure requirements

The IASB has refined some of the disclosure requirements in the DP, which were developed to require an entity to disclose useful information about how the timing, amount, nature and uncertainty of future cash flows of its financial instruments could be affected.

The IASB proposes to expand the objective and scope of IFRS 7 to include equity instruments that are within the scope of IAS 32. The IASB also proposes additional disclosure requirements based on its deliberations on the classification and presentation topics.

In particular, the IASB proposes to require an entity to disclose information about:

- The nature and priority of claims against the entity on liquidation arising from financial liabilities and equity instruments
- The terms and conditions of financial instruments with both financial liability and equity characteristics
- Terms and conditions that become, or stop being, effective with the passage of time
- The potential dilution of ordinary shares
- Instruments containing obligations to purchase the entity's own equity instruments
- Financial liabilities that include contractual obligations to pay amounts based on an entity's performance or changes in the entity's net assets
- Reclassifications of financial liabilities and equity instruments
- Judgements

The ED includes examples that are proposed to be added to the *Guidance on implementing IFRS 7.*

Presentation of amounts attributable to ordinary shareholders

The proposed amendments to the classification and disclosure requirements in IAS 32 and IFRS 7 are intended to improve the information an entity provides to users of financial statements about its issued financial instruments.

To further pursue this objective, the IASB also proposes to amend IAS 1 to require an entity to provide additional information about amounts attributable to ordinary shareholders. Applying the proposed amendments, an entity would:

- present issued share capital and reserves attributable to ordinary shareholders of the parent separately from issued share capital and reserves attributable to other owners of the parent in the statement of financial position;
- present an allocation of profit or loss and other comprehensive income attributable to owners of the parent between ordinary shareholders and other owners of the parent in the statement of comprehensive income;
- include each class of ordinary share capital and each class of other contributed equity in the components of equity reconciled in the statement of changes in equity or in the notes; and
- present dividend amounts relating to ordinary shareholders separately from amounts relating to other owners of the entity.

The ED includes illustrative examples that are proposed to be added to the *Guidance on implementing IAS 1*.

Disclosure requirements for eligible subsidiaries

The IASB also proposes amendments to the draft Accounting Standard S*ubsidiaries without Public Accountability: Disclosures*, which will be issued before the proposals in the ED are finalised. It will permit eligible subsidiaries to apply the recognition, measurement and presentation requirements in IFRS Accounting Standards with reduced disclosures.

The ED indicates which of the disclosure requirements proposed for IFRS 7 would apply under the reduced disclosure framework, based on the IASB's agreed principles for reducing disclosures.

Transition, effective date and comment period

The IASB proposes to require an entity to apply the proposed amendments retrospectively with the restatement of comparative information. However, to minimise costs, the IASB proposes not to require the restatement of information for more than one comparative period, even if the entity chooses or is required to present more than one comparative period in its financial statements.

For an entity already applying IFRS Accounting Standards, the IASB proposes:

- if it is impracticable (as defined in IAS 8 A*ccounting Policies, Changes in Accounting Estimates and Errors*) for an entity to apply the effective interest method in IFRS 9 *Financial Instruments* retrospectively, the entity is required to treat the fair value at the transition date as the amortised cost of the financial liability at that date;
- not to require the entity to separate the liability and equity components if the liability component of a compound financial instrument with a contingent settlement provision was no longer outstanding at the date of initial application;
- to require the entity to disclose, in the reporting period that includes the date of initial application of the amendments, the nature and amount of any changes in classification resulting from initial application of the amendments;
- to provide transition relief from the quantitative disclosures in IAS 8:28(f); and
- not to provide specific transition requirements in relation to IAS 34 *Interim Financial Reporting* for interim financial statements issued within the annual period in which the entity first applies the amendments.

The IASB does not propose any additional transition requirements for first-time adopters.

The ED does not propose an effective date. The effective date will be decided when the IASB redeliberates the proposals.

The comment period for the ED ends on 29 March 2024.

Further information

If you have any questions about the proposed amendments, please speak to your usual Deloitte contact.

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