IASB meeting

Date	**May 2024**
Project	**Financial Instruments with Characteristics of Equity**
Topic	**Feedback summary**
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Purpose of this paper

- This paper provides a high-level summary* of the feedback and key themes emerging from comment letters and investor outreach activities on the Exposure Draft *Financial Instruments with Characteristics of Equity*
- At this session we are not asking the IASB to make any decisions
- The staff plan to bring detailed comment letter analyses when the various topics are redeliberated at future IASB meetings

*The summary is not an exhaustive analysis of all views expressed and should be read as indicative only

Structure of this paper

Feedback summary

General comments

- General acknowledgement of the challenge to distinguish between financial liabilities and equity and need for additional guidance
- General support for:
  - the efforts made by the IASB, including the intent and objective of the proposed amendments
  - the approach to clarify some classification requirements in IAS 32 *Financial Instruments: Presentation* to reduce diversity in practice and address known practice issues; and
  - the addition of presentation and disclosure requirements to improve understandability and comparability for investors

BUT

- Although stakeholders agreed with a number of aspects, there was also disagreement on some of the proposals
- Various concerns about the impact on specific instruments issued in some jurisdictions (eg changes in classification outcomes) or potential for new interpretation issues to arise
- Requests for additional guidance/clarifications/examples on how to apply principles in practice

Overview of feedback

Topic	Feedback
Effects of relevant laws or regulations	
Fixed-for-fixed condition	
Obligations to purchase own equity instruments	
Contingent settlement provisions	
Shareholder discretion	
Reclassification of financial liabilities and equity instruments	
Disclosures	
Presentation of amounts attributable to ordinary shareholders	
Transition	
Disclosure requirements for subsidiaries without public accountability	

IFRS Accounting

Effects of relevant laws or regulations—Recap of proposals

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

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

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

Effects of relevant laws or regulations—Feedback

- Distinction between obligations created by laws/regulations and contracts is never 'black and white' (codification depends on civil vs common law framework)
- Some support for an ‘all-inclusive approach’ with/without exceptions
- Concerns raised included
    - proposals could result in significant disruption to practice—interpretation is based on paragraph 15 of IAS 32 ‘substance of the contractual arrangement’ or paragraph 5 of IFRIC 2 *Members’ Shares in Co-operative Entities and Similar Instruments* ‘terms and conditions include relevant local laws, regulations’
    - diversity across jurisdictions and potentially within the same consolidated group for economically similar instruments could impair comparability and result in structuring opportunities
    - unintended consequences on classification (eg regulated savings accounts/deposits and puttable instruments/co-operative shares where the obligation arises from the law)
    - lack of understandability on the drafting (eg ‘in addition to’) and need for judgement/extensive analysis could lead to new uncertainties and diversity in practice
    - whether laws or regulations include prudential guidelines or regulatory frameworks
- Requests for illustrative examples and additional guidance as well as additional disclosures
- Some suggested keeping the status quo until a fundamental review of IAS 32

Fixed-for-fixed condition—Recap of proposals

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

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

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

Fixed-for-fixed condition—Feedback

- General support for preservation adjustments but some concerns about down-round adjustments and volume weighted average price (VWAP) adjustments failing fixed-for-fixed condition
- Some disagreement that consideration must be fixed in the entity's functional currency and in the consolidated group determined based on the entity whose shares are being delivered
- General support for passage-of-time adjustments but large concerns about
    - criterion to require the adjustment to have the effect of fixing on initial recognition the amount of consideration per share in terms of a present value
    - adjustments linked to inflation and benchmark interest rates failing fixed-for-fixed condition
    - some adjustments linked to change of control of the issuer failing fixed-for-fixed condition
- General support for proposals related to share-for-share exchanges and choice of settlement
- Some suggestions to rethink the fixed-for-fixed rule—comparison to US GAAP or *Conceptual Framework for Financial Reporting* (liability definition excludes settlement in own shares)—concern about 'counterintuitive' effects in profit or loss
- Requests for more illustrative examples and additional guidance

Paragraph 23 of IAS 32

Obligations to purchase own equity instruments—Recap of proposals

Example	Proposed amendments

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

Obligations to purchase own equity instruments—Feedback

- Most feedback was provided in the context of NCI puts and although the type of NCI put (eg fair value vs fixed price) was not always specified, comments indicated that concerns mostly related to NCI puts exercisable at fair value or a proxy for fair value
- General concerns about
  - a ‘one size fits all’ approach due to diversity in practice
  - debiting ‘parent equity’ on initial recognition because of double counting on the balance sheet and the impact on banks’ regulatory capital ratios
  - remeasurement of the liability through profit or loss due to counterintuitive effects, double counting in the income statement, or the view that this is a transaction between owners
  - counterintuitive impact in profit or loss for distributions to NCI because the liability is affected
- Mixed views on measurement—some support fair value/amortised cost approach in IFRS 9 *Financial Instruments*, others support simplified ‘new measurement approach’ but want clarifications
- General support for accounting on expiry of written put
- Requests for illustrative examples and additional guidance (eg on assessing rights and returns, accounting on exercise of written put)
- Some support for the net approach (derivative accounting)
- A few suggested a separate project on NCI puts

Contingent settlement provisions—Recap of proposals

Paragraph 25 of IAS 32

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

Contingent settlement provisions—Feedback

- General support for
  - clarification that some financial instruments with contingent settlement provisions are compound instruments
  - aligning the initial and subsequent measurement approaches
  - clarification of 'not genuine' with some wording changes
- Some misunderstanding about the scope of the proposals (either existing liabilities with contingent settlement provisions or only liability components of compound instruments)
- Large disagreement about measurement deviating from IFRS 9 ie ignoring probability and estimated timing of contingency
- Concerns about
  - impact on hedge accounting if discretionary interest payments are recognised in equity instead of profit or loss
  - defining 'liquidation' or that the proposed definition may be too narrow
- Requests for additional guidance and examples (eg discount rate, if initial amount > fair value or multiple settlement amounts)
- A few suggested considering measurement issues as part of a separate standard-setting project to amend IFRS 9/amortised cost research pipeline project

Shareholder discretion—Recap of proposals

Paragraph 19 of IAS 32
If an entity does not have an **unconditional right to avoid** delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a financial liability [...]

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

The IASB is proposing a factors-based approach to help entities apply judgement

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

Shareholder discretion—Feedback

- Overall agreement that judgement is required to assess whether a shareholder decision is treated as an entity decision
- General support for factors-based approach but concerns about
  - how judgement should be applied
  - practical difficulty
  - potential inconsistency in application
  - unintended consequences
  - whether and how to reassess if factors evolve over time
- A few suggested other factors to consider and additional disclosure requirements
- Requests for illustrative examples and additional guidance (eg the meaning of 'routine in nature', 'change of control' decisions and decisions made by the controlling shareholder)

Reclassification of financial liabilities and equity instruments—Recap of proposals

IAS 32 requirements

- Paragraph 15 requires an issuer of a financial instrument to classify the instrument, or its component parts, on initial recognition
- No general reclassification requirements
- Paragraphs 16E-16F contain specific requirements for reclassifying puttable instruments and obligations arising on liquidation

Diversity in practice when there is a change in the substance of the contractual arrangement without a modification of the contract

Change in circumstances external to the contractual arrangement

Reclassification required prospectively from the date the change in circumstances occurs

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

Reclassification prohibited, disclosure required

Reclassification of financial liabilities and equity instruments—Feedback

- General support for
  - requiring reclassification when the substance of the contractual arrangement changes because of a change in circumstances
  - the timing of reclassification
- Large disagreement with the proposal to prohibit reclassification from financial liability to equity when the substance of the contractual arrangement changes due to passage-of-time changes
- Some requested clarifications on
  - whether changes in laws or regulations or changes in the factors relating to shareholder discretion can be considered as changes in circumstances requiring reclassification
  - the impact of reclassification to holders of financial instruments and the interaction with other IFRS 9 requirements related to modification and derecognition
- Requests for more illustrative examples and additional guidance (eg on the meaning and scope of ‘external to the contractual arrangement’)

IFRS Accounting

Disclosures—Recap of proposals

Not applicable to stand-alone derivatives

Terms & Conditions

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

Priority on liquidation

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

Potential dilution

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

Other disclosures

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

Scope of IFRS 7 *Financial Instruments: Disclosures*

Equity instruments issued

Disclosures—Feedback

- General support for additional information not captured by a binary classification and expanding the objectives of IFRS 7
- General concerns about application challenges and operational burden for preparers
- Nature and priority of claims on liquidation
  - some misunderstanding that proposals require the order of priority on liquidation resulting in concerns about complexity in groups with subsidiaries in multiple jurisdictions and with complex capital structures (the information is relevant at a separate entity level)
  - some viewed the proposed disclosure requirements as
    - contradicting a going concern view or irrelevant for regulated banks where resolution aims to prevent liquidation
    - incomplete (exclude non-financial liabilities)
    - challenging when considering varying jurisdictional laws and regulations where legal priority differs from contractual priority

Disclosures—Feedback *(Cont'd)*

- Terms and conditions
  - some support for additional disclosures to provide transparency and help understand complex instruments
  - some concerns about operational burden to prepare the information on an instrument-by-instrument basis
- Potential dilution of ordinary shares
  - some confusion with IAS 33 *Earnings per Share* and how to reconcile to diluted EPS
  - some agreed this information would be useful but suggested including the proposals in IAS 33 to limit them to listed companies
- Other disclosures
  - some support for the disclosure proposals on compound instruments, NCI puts and passage-of-time changes (if the IASB proceeds with the proposed reclassification prohibition)
- Some suggestions to reduce disclosure overload (eg narrow the scope or cross-refer to regulatory reports)
- Requests for additional guidance and illustrative examples about granularity and aggregation

Presentation of amounts attributable to ordinary shareholders—Recap of proposals

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

Equity

- Ordinary shareholders of parent
- Other owners of the parent

Statement of financial position

Line items on issued capital and reserves shown separately

Statement of financial performance

Results attributable shown separately

Statement of changes in equity

Each class of contributed equity shown separately

Distributions shown separately

Presentation of amounts attributable to ordinary shareholders—Feedback

- General support for additional information about amounts attributable to ordinary shareholders
- Mixed views on the presentation proposals
    - some supported the separate presentation of amounts attributable to ordinary shareholders
    - some disagreed due to significant concerns over the usefulness of information and practical challenges
    - a few did not provide firm views, primarily due to uncertainty on how to separate amounts attributable to ordinary shareholders from those attributable to other owners
- General concerns about lack of guidance on the basis and method to determine amounts attributable to ordinary shareholders
- Some suggested targeted improvements in this area using disclosures or another project instead
- Requests for more illustrative examples and additional guidance (eg to clarify the meaning of ‘ordinary shareholders’ and ‘other owners’)

Transition—Recap of proposals

Fully retrospective with restatement of comparative information

- Transition relief from some requirements
- Disclosure of nature and amount of any changes in classification resulting from initial application
- No specific relief from IAS 34 *Interim Financial Reporting* requirements for interim financial statements
- No additional transition relief for first-time adopters

Transition—Feedback

- General agreement with retrospective application but concerns raised about complexities and potential costs
- Practical difficulties and potential challenges raised
  - difficulties of gathering historical data
  - impact on hedge accounting due to classification changes
  - impact on business combinations and goodwill amounts
  - impact on classification of financial assets (from holder's perspective)
- Some suggestions to address the concerns
  - further transition reliefs required for
    - instruments that have expired/are derecognised before the date of initial application
    - hedge accounting
    - business combination transactions involving non-controlling interests
    - classification of financial assets
    - the proposed presentation requirements
  - prospective application rather than retrospective application
  - no restatement of comparatives (modified retrospective application)
  - longer implementation time before the effective date
- A few suggested requiring restatements for all comparative periods presented

Disclosure requirements for subsidiaries without public accountability—Recap of proposals

Principles for reducing disclosure requirements

- Liquidity and solvency
- Short-term cash flows, obligations, commitments and contingencies
- Measurement uncertainty
- Disaggregation of amounts
- Accounting policy choices

Proposed disclosures include:

- the nature and priority of claims on liquidation
- terms and conditions for financial instruments with characteristics of both debt and equity and effective changes with the passage of time
- financial instruments that include an obligation to purchase own equity instruments
- financial liabilities that include contractual obligations to pay amounts based on the issuer's performance or changes in net assets
- judgements in classifying an instrument

Disclosure requirements for subsidiaries without public accountability—Feedback

- Less feedback on this topic compared to others
- General agreement with the proposals to reduce disclosures for eligible subsidiaries
- Some reiterations of the same concerns raised in relation to the proposed disclosure requirements
- Some suggestions for further reduction in disclosures (eg nature and priority of claims on liquidation) considering costs vs benefits

Other matters—Feedback

A few respondents identified other matters for the IASB to consider

- incorporate a more principle-based exemption for treasury shares that would expand the scope of paragraph 33A of IAS 32 to other cases (eg where own equity instruments are traded and repurchased to economically hedge exposures to the fair value of own shares)
- clarify the classification of perpetual instruments and the interaction with paragraph AG6 of IAS 32 (perpetual debt instruments)
- introduce a new definition for financial liabilities or equity instruments

Summary of investor feedback

Classification—Feedback

- Outreach meetings mostly focused on presentation and disclosure proposals
- Some mentioned support for the classification proposals which enhance clarity and improve consistency
- Some disagreement or concerns on specific topics
  - effects of laws or regulations—diversity in classifying similar instruments across jurisdictions could undermine comparability and create structuring opportunities
  - NCI puts—the proposal to debit parent equity on initial recognition and recognise remeasurement changes through profit or loss would lead to double-counting of non-controlling interests, distortion of parent equity and two economic effects on parent earnings. This could adversely affect investors' analyses of metrics such as the price-to-book ratio and price earnings multiple
  - reclassification—prohibiting reclassification from financial liability to equity when the substance of the contractual arrangement changes due to passage-of-time changes would not provide relevant information to investors
- A few requested educational materials to reduce diversity in interpretation

Disclosures—Feedback

- General support for the disclosure proposals but some investors wanted more detailed/granular disclosures
- Potential dilution of ordinary shares—investors requested additional disclosures including
  - more information to assess the likelihood of the maximum dilution (eg fair value of derivatives)
  - cash flow implications (eg estimate of cash inflows from exercise of warrants) and effects on debt reduction from conversion of convertible bonds
  - maximum dilution of voting rights when they differ from maximum dilution of ordinary shares
  - reconciliation with number of shares used for calculating diluted earnings per share under IAS 33
- Priority on liquidation—investors expressed desires for more detailed waterfall of claims on liquidation that considers structural subordination and non-financial liabilities
- Terms and conditions—investors requested disclosures about deferred coupons and subordination factors to analyse the probability of default

Presentation—Feedback

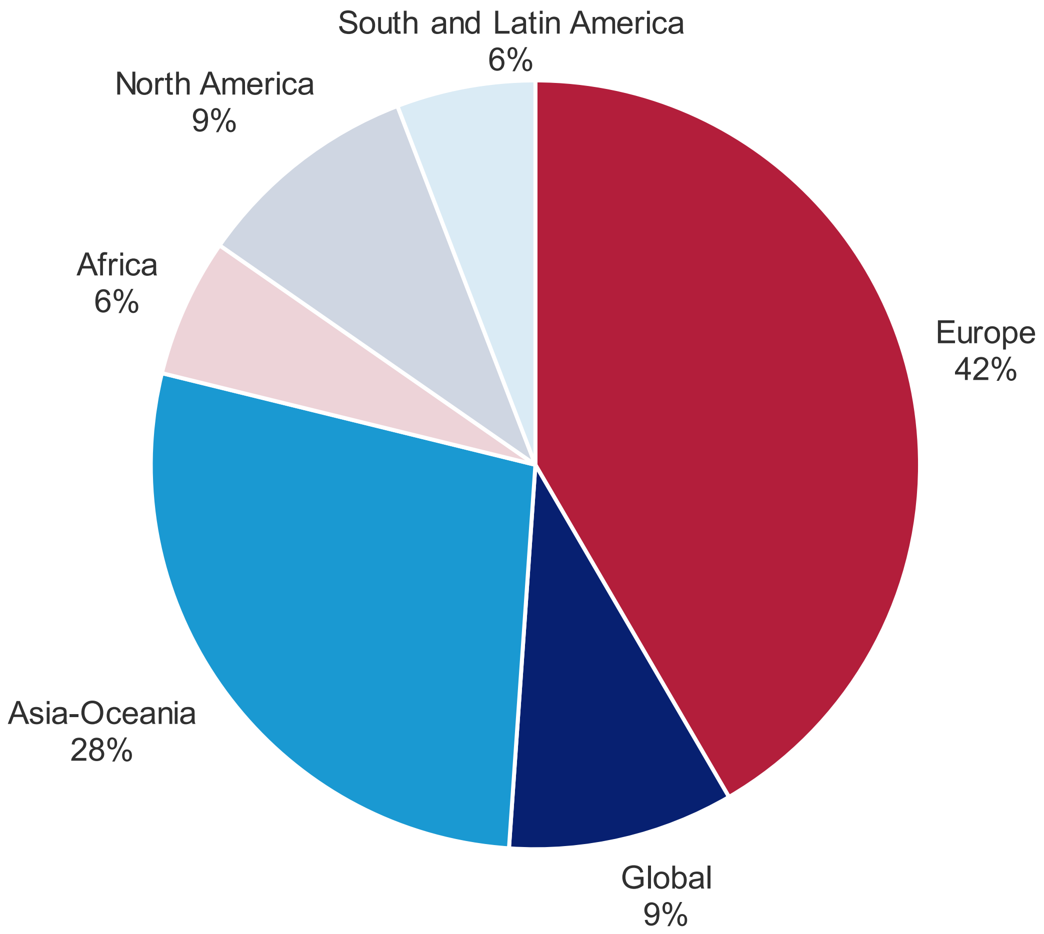
- General support for separate presentation of amounts attributable to ordinary shareholders in the financial statements, especially from equity investors
- To ensure understandability and comparability, some investors requested
    - guidance on the basis and method to determine amounts attributable to ordinary shareholders
    - disclosures of the assumptions and calculation methods used by companies to separate amounts attributable to ordinary shareholders
    - further disaggregation by different types of equity instruments (eg perpetual instruments, written call options)
- Some investors supported the proposals as a complement to the requirements in IAS 33, and anticipated a consistent method would be used to determine profit attributable to ordinary shareholders
- A few investors requested separate presentation to be extended to non-controlling interests and in cash flow statements

Appendix—Respondents' profile

Respondents’ profile

Respondent's profile—Geographical region

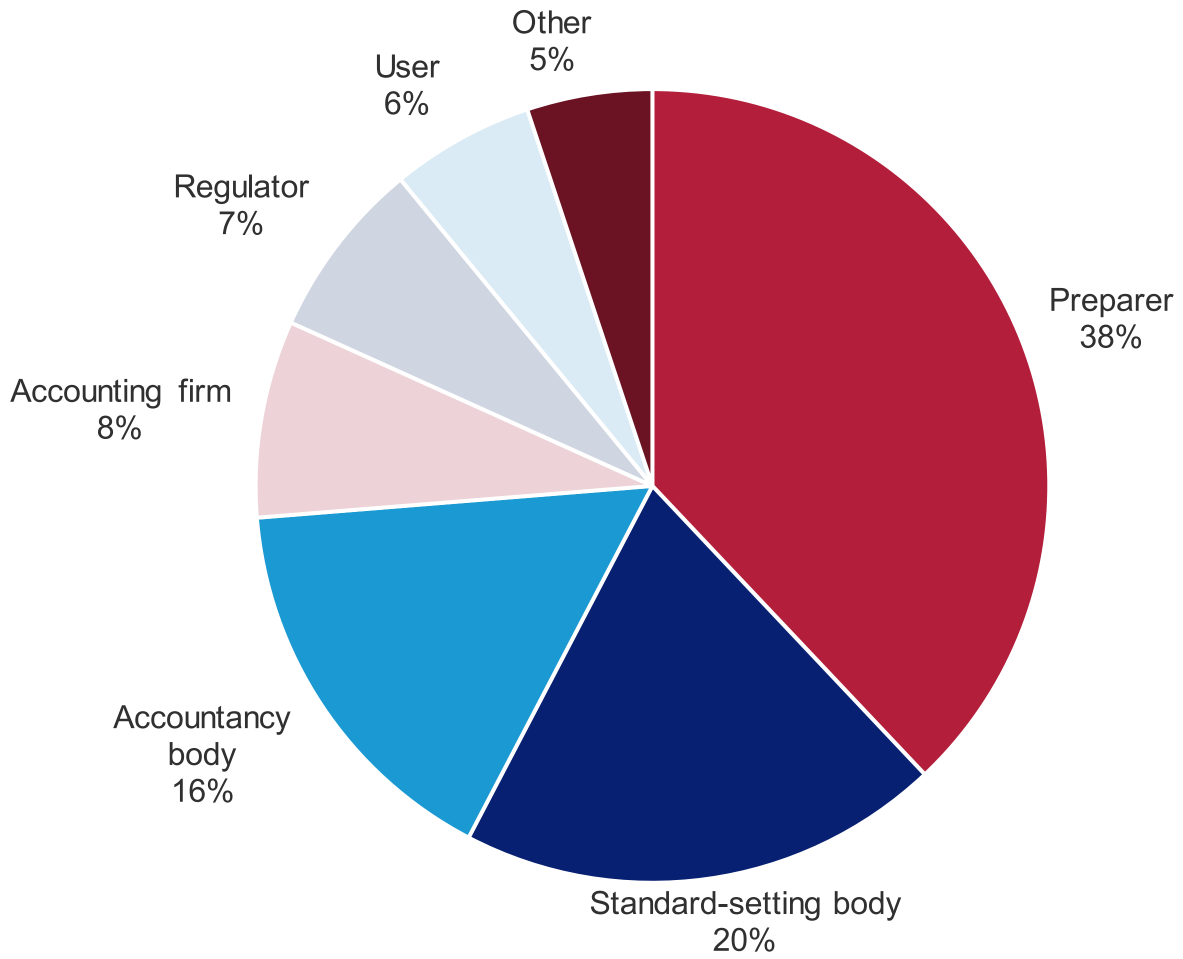
- 137 Comment letters received*



*Including 7 comment letters received after the deadline. Feedback from comment letters received up to 11 April 2024 has been incorporated in this paper.

Respondent's profile—Respondent type

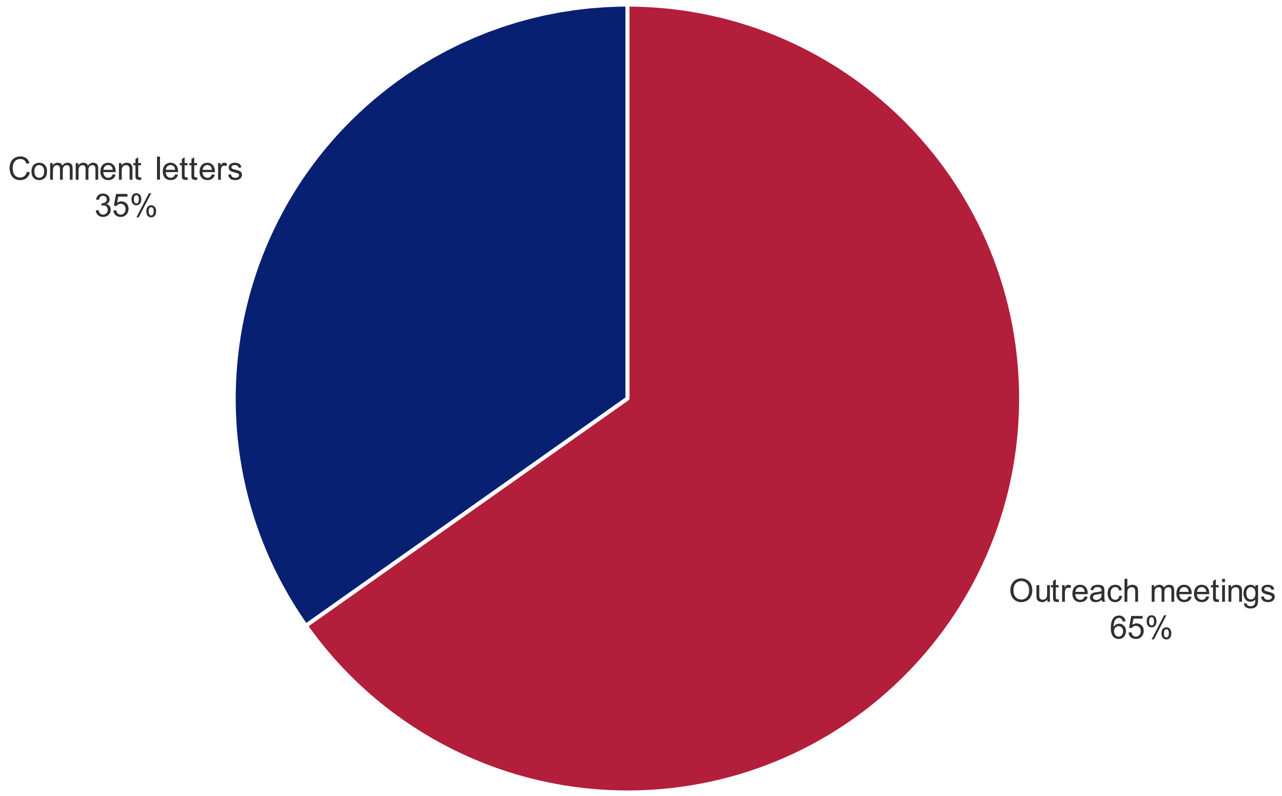
- 137 Comment letters received



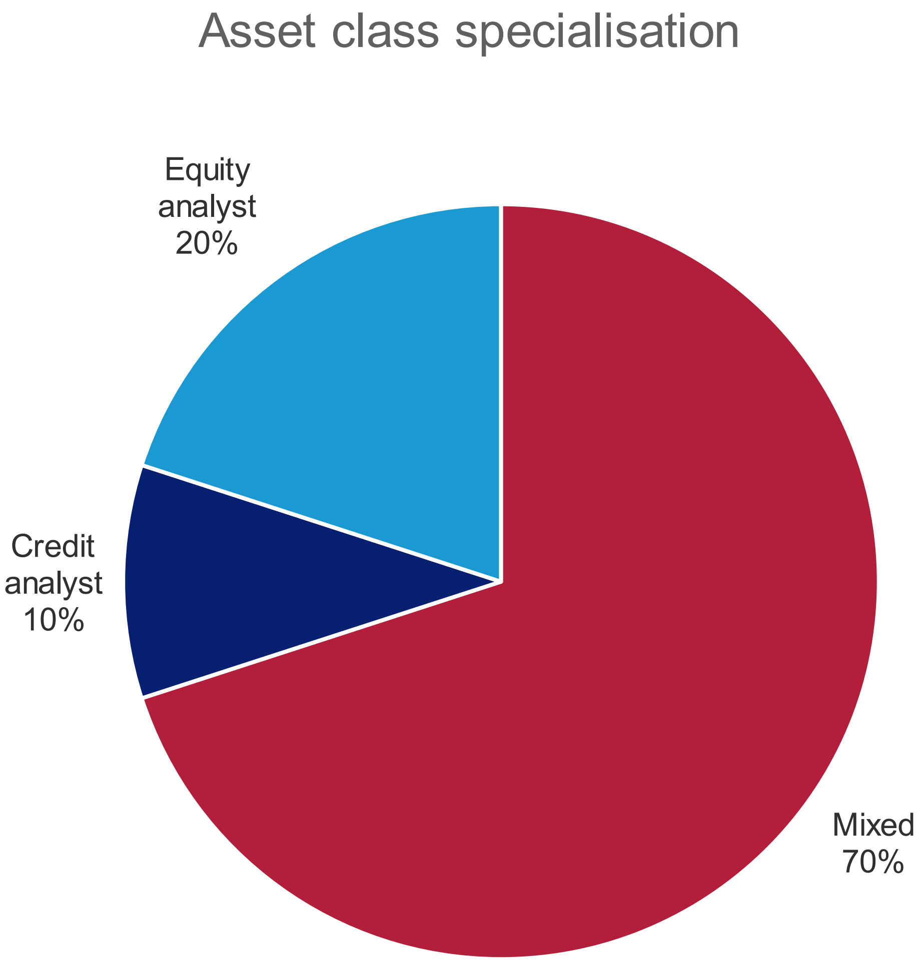
Investors’ profile

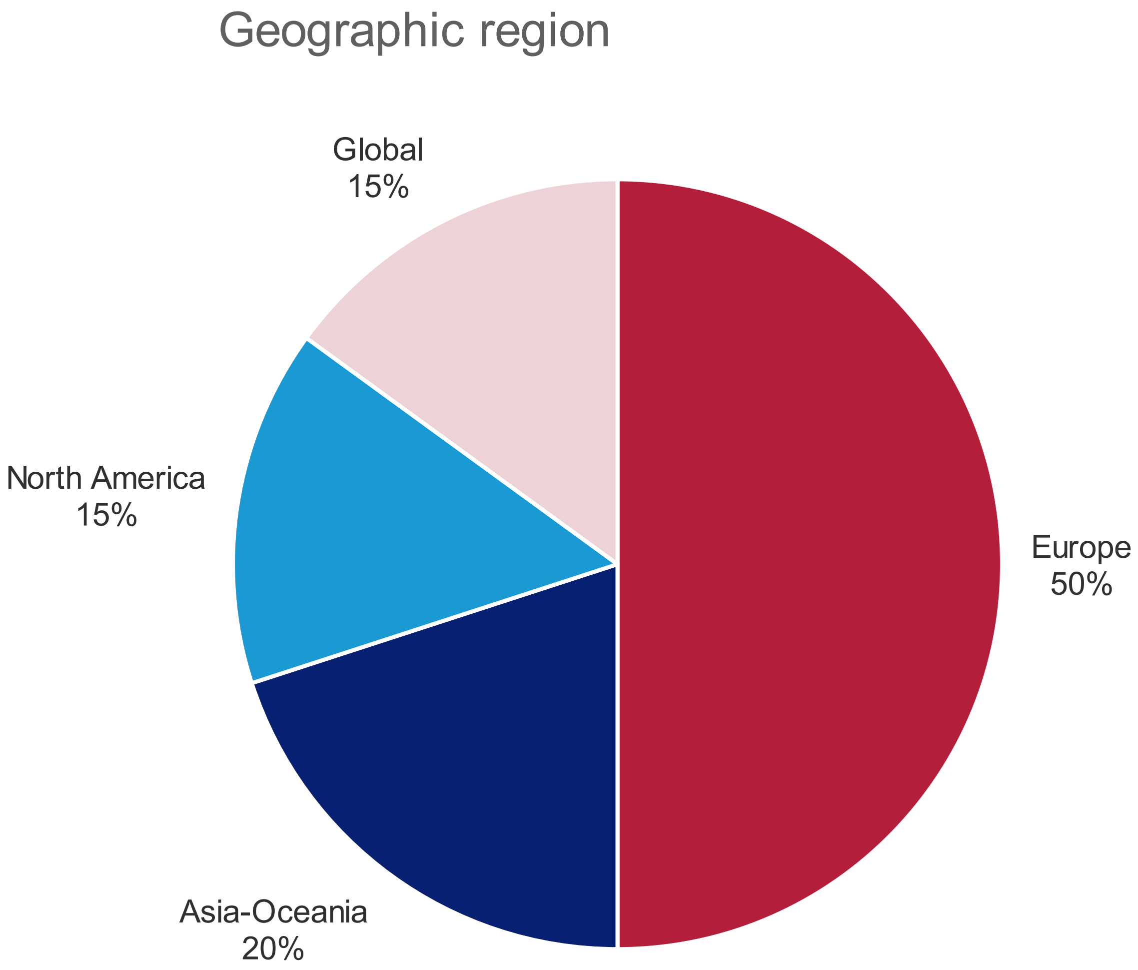
Source of feedback

- 15 Outreach meetings
- 8 Comment letters



Profile of investor outreach





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