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Financial Instruments with Characteristics of Equity

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Overview of the project

Purpose

- Improve information companies provide about issued financial instruments
- Address challenges in applying IAS 32 *Financial Instruments: Presentation*

Approach

- Clarify IAS 32 classification principles to address practice issues
- Improve presentation and disclosure
- Provide application guidance and illustrative examples

Next milestone

- Exposure Draft feedback: comments due 29 March 2024

Fixed-for-fixed condition for derivatives

Proposals

To be classified as equity, the amount of consideration for each own equity instrument must be (in the company's **functional currency**):

- fixed; or
- variable solely as a result of a preservation adjustment or passage-of-time adjustment or both.

Perpetual instruments

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

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

Regulatory Capital

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

Corporate Hybrids

Utilities
Telecommunications
Oil and Gas
Automobile

Feedback from equity investors

Most preferred liability classification

If equity classification retained, separate presentation and additional disclosure in notes would provide useful information

Proposals

- No change in classification
- New presentation and disclosure requirements

Effects of laws or regulations on contractual terms

Classify financial instruments as financial liabilities or equity by considering only contractual rights and obligations enforceable by law or regulation (that are in addition to those established 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**

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Shareholder discretion

IAS 32: if no **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 contractual obligation is at discretion of issuer's shareholders, **is a decision of shareholders treated as a decision of the company?**

Proposal: a factors-based approach to help companies apply judgement

- Factors to consider:
    - Decision is routine in nature
    - Decision relates to action / transaction initiated by management
    - Different classes of shareholders benefit differently from decision
    - Exercise of decision-making right enables redemption or payment of a return on shares
- Weighting applied to each factor depends on specific facts and circumstances.

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Reclassification between financial liabilities and equity instruments

IAS 32	• Issuer classifies a financial instrument on initial recognition • No general reclassification requirements • Specific requirements for reclassifying puttable instruments and obligations arising on liquidation

Proposals	**Change in circumstances** external to contractual arrangement	Reclassification required from date of change in circumstances
	Changes when existing contractual term becomes (or stops being) effective **with passage of time**	Reclassification prohibited; disclosure required

Contingent settlement provisions

Paragraph 25 of IAS 32

Example	Proposals
Contingent convertible instrument: • Issued at par • Convertible into variable number of shares to 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 (ignore probability). • Discretionary payments recognised in equity. • ‘Liquidation’—process that begins after an entity has permanently ceased its operations.

Paragraph 23 of IAS 32

Obligations to purchase own equity instruments

Example	Proposals
Written put options on non-controlling interests (NCI) and forward purchase contracts	• Contractual obligation to purchase own equity instruments presented on a **gross basis**—assists users in assessing exposure to liquidity risk. • Initial amount of financial liability removed from component of equity other than NCI/issued share capital. • Gains/losses from remeasurement recognised in profit or loss. • Same approach for initial and subsequent measurement (ignore probability). • On expiry of written put option, can transfer cumulative amount in retained earnings to another component of equity.

Presentation

Objective: to ensure amounts attributable to **ordinary shareholders** are clearly visible in statement of financial position, statement(s) of financial performance and statement of changes in equity

Equity

- Ordinary shareholders of parent
- Other owners of the parent

Statement of financial position

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

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Not applicable to stand-alone derivatives

Disclosures

Terms & Conditions

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

Priority on liquidation

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

Potential dilution

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

Other disclosures

- Reclassifications
- Remeasurement gains/losses on particular liabilities
- Obligations to redeem own equity instruments
- Compound instruments–initial allocation between components

Scope of IFRS 7

Equity instruments issued

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