# FICE: Update on IASB activities
# Issues Paper

## Objective

1 The objective for this session is to:

(a) Update EFRAG TEG members as to the IASB activities on the FICE DP based on feedback received; and

(b) Consider any other aspects of importance to Europe that the IASB should consider in future months.

2 An update from EFRAG FIWG discussion on 22 January 2020 will be provided during the meeting.

## Project direction

3 Since March 2019 the IASB has been considering the feedback received on the different sections of the IASB's Discussion Paper *Financial Instruments with characteristics of Equity* (DP).

4 At its September 2019 meeting, the IASB discussed the direction of the FICE project. The following alternatives have been considered:

(a) **Fundamental review to develop a new approach** to distinguish financial liabilities from equity instruments. This would be a fresh start approach leveraging on the feedback received;

(b) **IASB's preferred approach in the DP** subject to some clarifications or modifications based on the feedback received;

(c) **Clarifying amendments to IAS 32** focusing on addressing the issues that arise in practice by clarifying the underlying principles of IAS 32;

(d) **Narrow-scope amendments to IAS 32** for a specific fact pattern or a specific feature of financial instruments without clarifying existing principles or underlying rationales; and

(e) **Disclosure-only project** refining the disclosure proposals in the DP assuming classification requirements remain unchanged from IAS 32.

The IASB tentatively decided to follow **alternative (c)** above.

*EFRAG Secretariat analysis*

5 The EFRAG Secretariat considers that this alternative is the most aligned with the EFRAG position stated in its comment letter (here), which highlighted the importance of addressing the issues that arise in practice in a timely manner.

**Project plan**

6 In October 2019, the IASB discussed the overall objectives of the project, the issues that arise in practice which could be address within the project, and the project timetable for indicative commencements of deliberations on each issue between Q4/2019 and H1/2021. The IASB staff identified the following list of issues that could be addressed within the project on making clarifying amendments to IAS 32:

(a) classification of financial instruments that will or may be settled in the issuer's own equity instruments, e.g. 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, e.g. accounting for written put options on non-controlling interests (**NCI puts**);

(c) accounting for financial instruments that contain **contingent settlement provisions**, e.g. 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, e.g. 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, e.g. **perpetual** financial instruments.

7 In appendix 1 the EFRAG Secretariat has included a table illustrating the order in which the IASB staff expects to bring the analyses of issues to the IASB for its deliberations.

8 No decisions were made at this meeting.

*EFRAG Secretariat analysis*

9 The EFRAG Secretariat observes that the identification of issues that commonly arise in practice on application of IAS 32 is reasonable. In addition, the EFRAG Secretariat concludes that the approach followed would not immediately impact the accounting of cooperative entities under IFRIC 2.

10 Under the approach followed by the IASB, it is not clear whether the IASB will also extend the potential improvements made to IAS 32 also other standards (including IAS 33), as was suggested in EFRAG's comment letter on the FICE DP.

11 On the suggested timetable, the EFRAG Secretariat notes that the IASB agenda consultation in 2020 may give the opportunity to emphasise the priority of the project.

**Summary of the IASB discussions on the fixed-for-fixed condition**

12 At its December 2019 meeting, the IASB staff presented its analysis on financial instruments settled in own equity instruments: fixed-for-fixed criterion (**issue (a)** in paragraph 5 above) to the IASB in December 2019.

13 When analysing the rationale for the fixed-for-fixed criterion, it was noted that the issuer of an equity derivative should not be exposed to other risks or other variables that it would not be exposed to by directly issuing the underlying equity instruments. In contrast, when there is exposure to other variables (including foreign currency exchange rates), the definition of an equity instrument would not be met. Thus, the fair value of an equity derivative on settlement would only be affected by fluctuations in the underlying equity instruments and not be affected by fluctuations in other variables, i.e. exposed to equity price risk only and not to other risks.

14 A key issue with the fixed-for-fixed criterion was identified to be whether “fixed” means “never changes”, “is predetermined” either in the sense that any or only particular types of predetermined variability can be considered fixed, or “something else”.

15 The IASB staff analysed that predetermined variability would not conflict with the fixed-for-fixed criterion if it would reflect either preservation adjustments or passage of time adjustments.

16 Preservation adjustments arise under some anti-dilution or “make-whole” provisions that are meant to compensate the holder of an equity derivative so that it remains in the same position relative to the holder of the underlying equity instrument when a dilutive event occurs. In contrast to this, adjustments like down-round features that favour the equity derivative holder at the expense of the holder of the underlying equity instrument would not be deemed preservation adjustments.

17 Passage of time adjustments were analysed as compensating the issuer for the fact that settlement of the derivative will inherently take place in the future, and there is no uncertainty around the passage of time. An analogy was drawn to a series of options where each would meet the fixed-for-fixed criterion when the strike price and/or the number of equity instruments is predetermined and only varies with the passage of time.

18 Against this background, the following **clarifications** to IAS 32 were considered:

(a) A derivative on own equity that meets the fixed-for-fixed condition should have a fair value on the settlement date (settlement value) that is:

(i) only affected by fluctuations in the price of the underlying equity instruments (exposed to equity price risk); and

(ii) not affected by fluctuations in other variables that the holder of the underlying equity instruments would not be exposed to (not exposed to other risks).

(b) If a derivative is subject to any adjustments to the amount of cash or another financial asset, or the number of own equity instruments, the adjustments would not preclude the derivative from meeting the fixed-for-fixed condition if the adjustments:

(i) preserve the relative economic interests of the derivative holder and the underlying equity instrument holder (‘preservation adjustments’); or

(ii) compensate the issuer for the fact that the derivative will be settled at a future date (‘passage of time adjustments’).

19 Albeit no decisions were made at this meeting, the IASB members appreciated how the fixed-for-fixed principle was addressed in the agenda paper and generally agreed with proposed direction of clarifications in IAS 32.

20 In particular, the IASB discussed and the IASB staff will further explore the following areas in more detail:

(a) the perspective from which exposure to equity price risk is assessed (which would rather be the holder’s perspective);

(b) preservation adjustments (some clauses could be meant to be protective in nature; or whether the absence of such features could have impact on equity classification)

(c) passage-of-time adjustments (whether these should only reflect time value of money)

(d) the perspective of the issuing entity (in particular when there are different functional currencies within a group, this would be the perspective of the reporting entity)

*EFRAG Secretariat analysis*

21 The EFRAG Secretariat observes that the IASB staff's analysis and proposed clarifications can be useful when applying the fixed-for-fixed criterion to equity derivatives in practice.

22 EFRAG's comment letter on the FICE DP suggested to consider improving IAS 32 by "incorporating some of the detailed guidance in paragraphs 4.45 to 4.66 of the DP focused on variables that have resulted in questions and difficulties when applying the fixed-for-fixed condition (e.g. reference point to determine whether the transaction involves foreign currency, anti-dilution provisions and time value of money)." The EFRAG Secretariat observes that the initial discussions of the IASB included these questions.

23 As the IASB staff has concluded, the fixed-for-fixed criterion is the main source of accounting challenges in practice and application of the fixed-for-fixed criterion to certain financial instruments may differ in practice. Accordingly, if the clarifications were made to IAS 32 as proposed, this could – depending on the current application of the fixed-for-fixed criterion - require a change in accounting e.g. to

(a) derivatives with down-round features,

(b) certain mandatorily convertible bonds (e.g. such with a minimum number of shares floor), or

(c) when the settlement is subject to foreign currency adjustments (e.g. when issuers of equity instruments within a group have different functional currencies).

**Questions for EFRAG TEG**

24 Are there any further topics, apart from the ones mentioned in paragraph 6, that IASB should consider as part of this project?

25 Does EFRAG TEG have further observations on the application of the fixed-for-fixed criterion and the suggested clarifications by the IASB staff?

## Appendix 1 Indicative project timeline

26 The following table illustrates the order in which the IASB staff expects to bring the analyses of issues to the IASB for its deliberations:

| Classification | Presentation and disclosure | Indicative commencement |
|---|---|---|
| • Financial instruments settled in own equity instruments (including fixed-for-fixed condition) | • Research and outreach. | Q4 2019 |
| • Contingent settlement provisions<br>• Effects of laws and regulation | • Further development of the disclosure proposals in the 2018 DP | H1 2020 |
| • Obligations that only arise on liquidation (eg perpetual instruments)<br>• Obligations to redeem own equity instruments (including NCI puts) | • Development of any further disclosure requirements<br>• Further development of particular presentation proposals in the 2018 DP | H2 2020 |
| • Reclassification and any other issues<br>• Overall consistency check and evaluation of classification principles<br>• 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 | | H1 2021 |