European Securities and Markets Authority

The Chair
Date: 12 October 2020
ESMA32-63-1052

Sue Lloyd
Chair of the IFRS IC
Columbus Building
7 Westferry Circus
Canary Wharf
London E14 4HD
United Kingdom

Agenda Item Request: Derecognition of a warrant (IAS 32)

Dear Ms Lloyd,

The European Securities and Markets Authority (ESMA) is an independent EU Authority that enhances the protection of investors and promotes stable and well-functioning financial markets in the European Union (EU). ESMA achieves this aim by building a single rule book for EU financial markets and ensuring its consistent application across the EU. In the context of ESMA's supervisory convergence work in the area of financial reporting, I would like to raise with you the following issue related to the application of IAS 32 *Financial Instruments: Presentation*.

As a result of work carried out by national competent authorities and ESMA's coordination activities regarding financial information prepared in accordance with IFRS, ESMA has identified diversity in the application of the requirements of IAS 32 in relation to accounting for warrants that are initially classified as liability and then re-classified as equity.

Accordingly, ESMA kindly suggests that the IFRS Interpretations Committee (IFRS IC) considers clarifying the relevant accounting requirements. A detailed description of the case is set out in the appendix to this letter.

In case you have any questions or comments regarding this letter, I suggest you contact Evert van Walsum, Head of the Investors and Issuers Department (Evert.vanWalsum@esma.europa.eu).

Yours sincerely,

Steven Maijoor

APPENDIX – DETAILED DESCRIPTION OF THE ISSUE

1. The terms and conditions of warrants or similar financial instruments may provide the holder with the right to buy equity instruments of the issuer of the warrants for an exercise price that will be fixed at a future date. When the issuer accounts for such warrants upon initial recognition, it has to apply the requirements in IAS 32 and to determine whether these instruments qualify as financial liabilities or equity instruments. The variability in the exercise price whose fixing is foreseen at a future date would generally result in a classification of these instruments as financial liabilities pursuant to paragraph 16 of IAS 32.
2. However, when the exercise price is subsequently fixed, some issuers have considered the possibility of derecognising the financial liability and recognising the warrants as equity instruments given that the fixed-for-fixed condition in IAS 32 would at this stage be met. In other words, some issuers believe that an accounting policy choice is available to re-classify the warrants as equity instruments.
3. As part of their monitoring and supervisory activities, ESMA and national enforcers have identified divergent application of the abovementioned requirements of IAS 32. ESMA understands that this issue might be present in multiple jurisdictions.
4. ESMA notes that IAS 32 does not provide explicit guidance with regard to whether an accounting policy choice is available to issuers to re-classify a financial liability if, as foreseen in the terms of the financial instrument, the price fixing occurs at a later stage and therefore the fixed-for-fixed condition would be met at that point in time. As a result, ESMA has observed that the following accounting policies have been developed on the basis of the accounting requirements of IAS 32:
   a. No re-classification of the warrant is admitted when a change in its features, that was already foreseen in its terms and conditions upon issuance, occurs after initial recognition (view 1);
   b. An accounting policy choice exists with regards to the re-classification of the warrant when a change in its features, that was already foreseen in its terms and conditions upon issuance, occurs after initial recognition (view 2); and
   c. A requirement exists under IFRS with regards to the re-classification of the warrant when a change in its features, that was already foreseen in its terms and conditions upon issuance, occurs after initial recognition (view 3)

View 1: No re-classification of the warrant is admitted when a change in its features, that was already foreseen in its terms and conditions upon issuance, occurs after initial recognition

5. Paragraph 15 of IAS 32 requires an issuer of a financial instrument to "*classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument*".

6. Paragraph 3.3.1 of IFRS 9 provides that: "*An entity shall remove a financial liability (or a part of a financial liability) from its statement of financial position when, and only when, it is extinguished—ie when the obligation specified in the contract is discharged or cancelled or expires*." Paragraph 3.3.2 further specifies that: "*a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability*".
7. Proponents of view 1 argue that no possibility is envisaged in IAS 32 to reclassify a financial instrument after initial recognition. In the fact pattern presented, the warrant was not subject to a substantial modification of its terms since the original terms of the warrants already envisaged that the fixing of the exercise price would occur at a future date.
8. Under this view, it is not possible neither to reclassify the instrument nor to derecognise it since the derecognition conditions in IFRS 9 are not satisfied. Proponents of this view, believe that the execution of one of the terms of the financial instrument, i.e. the postponed fixing of the exercise price of the warrant, neither constitutes an extinguishment of the liability nor a modification of the terms of the warrant.

View 2: An accounting policy choice exists with regards to the re-classification of the warrant when a change in its features, that was already foreseen in its terms and conditions upon issuance, occurs after initial recognition

9. On the other hand, proponents of view 2 consider that, following the fixing of the exercise price, the substance of the warrant has changed into that of an equity instrument since the warrant would then satisfy the fixed-for-fixed condition in IAS 32.
10. Therefore, under this view it would be misleading for users of financial statements to continue classifying the instrument as a financial liability even after the fixing of the exercise price.
11. Proponents of this view note that IAS 32 does not prevent an entity for re-assessing the nature of the financial instrument and its classification to reflect a change in facts and circumstances. Under this view, the entity would therefore be able to exercise an accounting policy choice and re-classify the instrument as an equity instrument following the fixing of the exercise price.

View 3: A requirement exists under IFRS with regards to the re-classification of the warrant when a change in its features, that was already foreseen in its terms and conditions upon issuance, occurs after initial recognition

12. Under view 3, the same arguments as to those indicated regarding view 2 would apply, but proponents of this view argue that it is required to reclassify the warrant given that the effective terms of the instrument have changed due solely to the passage of time.
13. Proponents of view 3 consider that the requirements in paragraph 3.3.1 of IFRS 9 for derecognition of a financial liability are met when due to the passage of time the features of the warrant change into that of an equity instrument even if this situation was already envisaged as part of the terms of the financial instrument upon its issuance.

Request

14. ESMA seeks clarification on whether it is possible to reclassify a warrant as an equity instrument following the fixing of its exercise price which occurred, as foreseen at the issuance date in the terms of the instrument, after initial recognition when the instrument was classified as a financial liability.
15. ESMA observes that different views have been expressed regarding whether such re-classification is possible and whether entities have an accounting policy choice in this regard. Consequently, ESMA suggests that the IFRS IC clarifies the applicable requirements.