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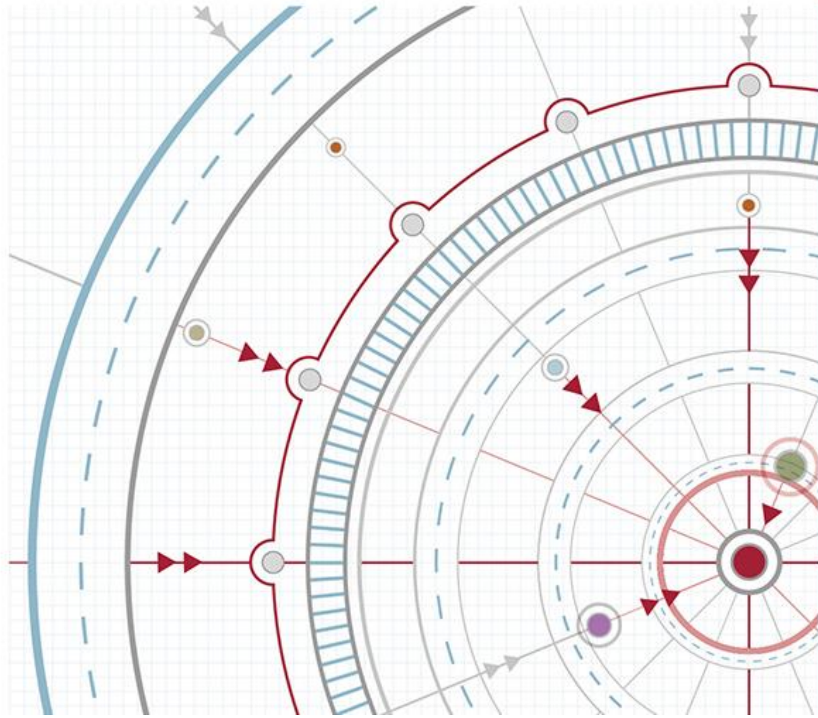


# Financial Instruments with Characteristics of Equity

## Part A
## Overview

The views expressed in this presentation are those of the presenter,
not necessarily those of the International Accounting Standards Board (the Board) or IFRS Foundation.

# Agenda – Part A



- About the project
- Challenges identified and proposed response
- Overview of proposals to be included in the Discussion Paper

# About the project



- This is a research project
- This research project is investigating:
  - the classification of liabilities and equity; and
  - presentation and disclosure requirements for both liabilities and equity.
- Why are we doing this project?
  - resolve debates about underlying rationale of distinction between liabilities and equity
  - issues submitted to IFRS Interpretations Committee but remain unresolved
- The Board is considering various ways of overcoming the challenges identified when applying IAS 32, not just classification.

# Challenges identified and proposed response



## Challenges identified

(1) Polarised information outcomes from classification

(2) Continuing debate about classification outcomes

(3) Difficulty applying IAS 32 unresolved Interpretations Committee submissions

Financial statements cannot depict the wide range of claims with a single distinction

Financial liabilities

Instruments that present classification challenges under IAS 32

Equity instruments

## Response

Financial liabilities

Liabilities with either:
- equity-like payoffs; or
- no obligation to transfer resources

Classes of equity other than ordinary shares

Equity instruments

This project is not just about classification as liabilities or equity

(1) Reinforce the underlying rationale of the distinction between L/E

(2) Use presentation and disclosure to communicate similarities and differences not captured by L/E

(3) Improve consistency, completeness and clarity

# Proposals



Preliminary views in the Discussion Paper include:

- The underlying rationale of classification between liabilities and equity
- Presentation proposals for subclasses of liabilities and equity
- Potential disclosures
- Improvements to the consistency, completeness and clarity of the requirements (in particular for derivatives on own equity)

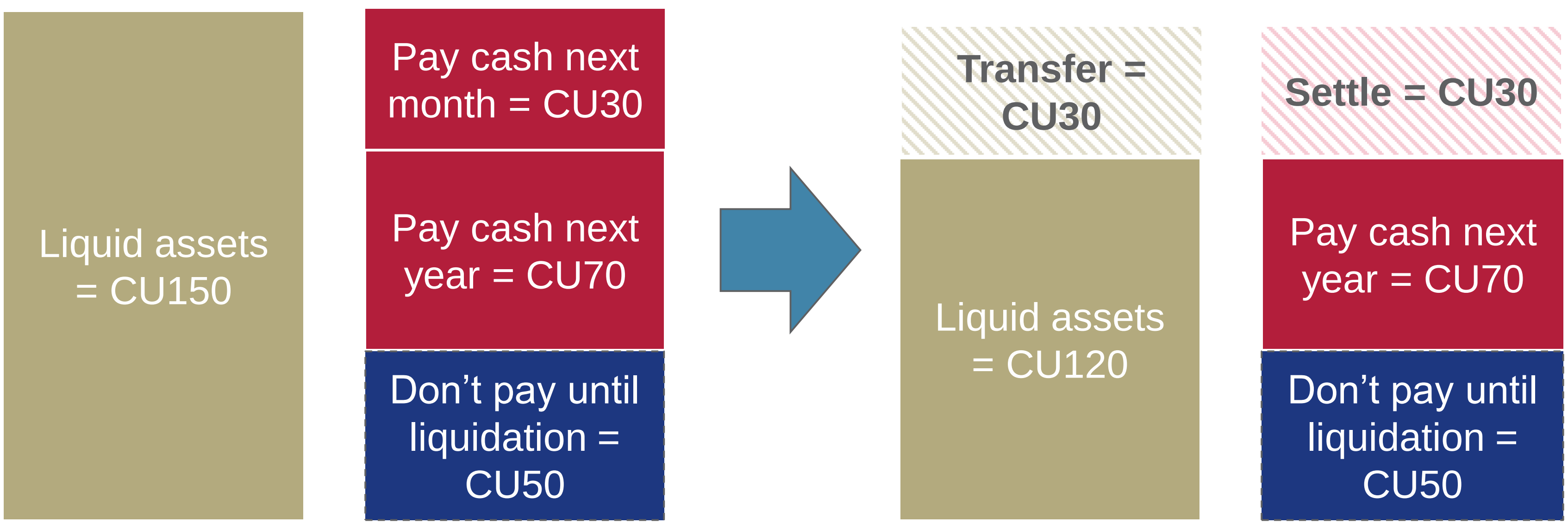
# Classification – underlying rationale



- Classify as a liability claims with either an obligation:
  - to *transfer economic resources* at particular points in time other than at liquidation
    - eg obligations to deliver cash at specified dates or on demand
  - for a *specified amount* independent of the economic resources of the entity (irrespective of ‘form’) (so not dependent on the entity’s ‘residual’)
    - eg fixed monetary amounts regardless of settlement requirements
- Classify as equity claims that are not liabilities:
  - do not require transfer of resources at a time other than liquidation, <u>and</u> that depend on the residual amount
    - eg ordinary shares

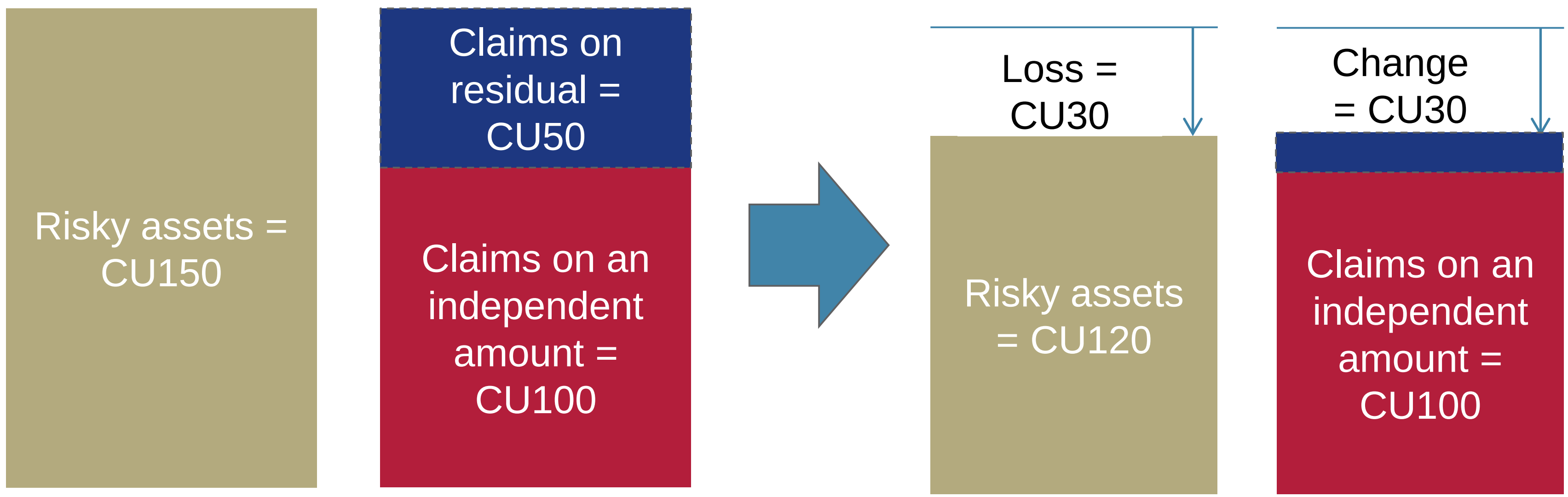
# Classification: Transfer of economic resources

- Timing of resource transfer requirements relevant for assessing:
  - Whether the entity will have the assets required when it needs to transfer them
  - Liquidity (current ratio and quick ratio)
  - ‘Flighty’ vs long-term funding



# Classification: Amount of the obligation

- Amount independent of economic resources relevant for assessing:
  - Whether the entity has sufficient economic resources
  - How claims respond to gains/losses on economic resources
  - Financial leverage and flexibility (eg interest coverage, leverage ratio, debt overhang)



# Classification – ‘Puttables’ Exception



- Preliminary view is that the exception in IAS 32 to treat some liabilities as equity may still be needed
  - exception applies to financial instruments as described in paragraphs 16A and 16B [or 16C and 16D] of IAS 32
  - retaining the exception would address previous concerns with classifying some puttable instruments that represent the most residual claim to the net assets of the entity as liabilities.
  - disclosure requirements would provide sufficient information for users to estimate the potential cash outflows arising from the claims which meet the exception in paragraphs 16a and 16B [or 16C and 16D].

# Classification - derivatives



- Discussion Paper will propose:
  - continue to classify the derivative in its entirety as liability or equity
  - classification principle that applies the classification approach to the derivative as a whole.
  - additional requirements to ensure consistent accounting for similar economic outcomes, in particular for compound instruments and redemption obligations (eg in written puts on own equity).
- Discussion Paper will include analysis of how the proposals might help alleviate challenges with existing requirements (See Appendix)

# Presentation: Liabilities



- Separate presentation requirements for some liabilities that have different features
  - statement of financial position and statement of financial performance
- For some liabilities, separately present gains and losses
  - if the amount of the obligation to transfer cash or other financial assets solely depends on the entity's share price
    - eg shares redeemable at fair value, net cash settled fixed-for-fixed derivatives
  - foreign currency fixed-for-fixed derivatives in some cases
    - eg conversion option in foreign currency convertible
- The Discussion Paper will explore separate presentation of these gains and losses within profit or loss and using other comprehensive income
  - Preliminary view present separately in OCI. Discuss whether to recycle into profit or loss

# Presentation: Equity



- The Discussion Paper will explore separate presentation requirements for equity claims other than ordinary shares
  - Update carrying amounts in statement of changes in equity
  - Attribute profit or loss and OCI to
    - non-derivatives: use existing requirements in IAS 33 *Earnings per Share*
    - derivatives: a number of approaches considered (see Appendix)

# Disclosure



- The Discussion Paper will explore the following potential disclosures:
  - the priority of claims on liquidation (eg capitalisation table)
  - the potential dilution of ordinary shares
  - terms and conditions

# Next steps



- Board has granted permission to begin drafting and balloting Discussion Paper
- NSS Support is needed to help us gather feedback on the Discussion Paper
- Based on feedback received:
  - Develop project proposal to amend, or replace, IAS 32
  - One possible outcome of the research is a recommendation to consider adding a project to amend the Conceptual Framework in relation to distinguishing between liabilities and equity

# Appendix: Practical issues addressed by the proposed approach



| Challenges | Outcomes |
|---|---|
| Application of the ‘fixed for fixed’ condition | Clarifies that the underlying principle of the ‘fixed-for-fixed’ condition. |
| Accounting for put options written on non-controlling interests (NCI puts) | 1) Achieves consistent classification outcomes for arrangements with similar economic outcomes, eg convertible bonds and written put options<br>2) Requires separate presentation of gains and losses for liabilities with amounts linked to share price eg when shares can be redeemed at fair value |
| Accounting for bonds that are contingently convertible to equity | Clarifies classification of liability and equity components. The contingent conversion option would be classified as equity only if it solely depends on the residual amount. |

# Appendix: Presentation of equity derivatives



- The Discussion Paper will discuss costs and benefits of different approaches to attribution of profit or loss and OCI to equity derivatives
  - For example, one approach will attribute based on changes in fair value of equity instruments other than ordinary shares.
    - This will result in measuring the effect on ordinary shares as if the claim were liability classified.
    - However, remeasuring at fair value will introduce some of the issues that we are addressing for liabilities linked to share price.
  - Other approaches include:
    - Calculations, similar to diluted EPS, that are based on fair value instead of intrinsic value and apply to all instruments regardless of whether they are dilutive (reduced EPS) or anti-dilutive (increased EPS)
    - Not attributing any amounts, rely solely on disclosure

# Attribution of profit or loss to other classes of equity (Simplified illustration)



| In Currency Units (CU) | Attribute based on fair value | Attribute similar to EPS |
|---|---|---|
| **Total Profit or loss** | **15,000** | **15,000** |
| **Attributed to:** | | |
| Warrants | 5,000 | 900 |
| Ordinary shares | 10,000 | 14,100 |
| **Comparison to EPS:** | | |
| Amount attributed to ordinary shares / total shares outstanding (1000) | 10 | 14.10 |
| Diluted EPS per IAS 33 | 14 | 13.50 |

# Statement of Changes in Equity (Simplified illustration of FV approach)



| In Currency Units (CU) | Warrants | Ordinary shares (inc retained earings etc) | Total equity |
|---|---|---|---|
| **Start of the year** | **-** | **10,000** | **10,000** |
| Warrants issued | 5,000 | - | 5,000 |
| Attribution of total comprehensive income | 5,000 | 10,000 | 15,000 |
| **End of the year** | **10,000** | **20,000** | **30,000** |

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