Financial Instruments with Characteristics of Equity

Webinar 4: Classification of compound instruments and redemption obligation arrangements
July 2018
Before we start

• You can download the slides by clicking on the button below the slides window

• This webinar is a recording (it is not live), so we are unable to take any questions

• The views expressed are those of the presenters, not necessarily those of the International Accounting Standards Board (the Board) or IFRS Foundation
# Financial Instruments with Characteristics of Equity – Webinar Schedule

## Previous Webinars
- Overview of the Discussion Paper
- The Board’s preferred approach and classification of non-derivative financial instruments
- Classification of derivatives on own equity

## This Webinar
- Classification of compound instruments and redemption obligation arrangements

## Future webinars
- Presentation of equity instruments applying the Board’s preferred approach
- Presentation of financial liabilities applying the Board’s preferred approach
Interaction between Section 4 and Section 5 of the Discussion Paper

Section 4 classification of derivatives on own equity

- All standalone derivatives on own equity
- All embedded derivatives on own equity that are separated
- **EXCEPT** those that may require extinguishment of own equity instruments

Section 5 compound instruments and redemption obligation arrangements

- All compound instruments
- All derivatives that may require extinguishment of own equity instruments

Once a non-derivative liability host is identified any resulting own equity derivatives are classified using Section 4 of the Discussion Paper.
Derivatives that may require extinguishment of own equity instruments

- For example, consider a forward contract to purchase 100 own shares in one year’s time for a payment of CU100.

  ![Diagram](image)

- In effect, the derivative has changed the characteristics of the outstanding 100 shares to an unavoidable obligation to pay a fixed amount of cash.

- The obligation to pay CU100 has both the timing and amount features of a financial liability.
Compound instruments and redemption obligation arrangements

**Compound instruments:**
contain both a liability and an equity component.

For example, a share conversion option that has the features of equity and is embedded in a bond.

**Redemption obligation arrangements:**
derivatives that require extinguishment of own equity instruments considered in conjunction with the underlying equity instrument to be extinguished.

For example, a written put option on own shares.

Ultimate outcome is either own shares outstanding or payment of cash – **and the entity cannot control the outcome**
Convertible bonds and written put options

Convertible bond — at maturity, the holder has a choice to either receive CU100 in cash or convert the bond to 100 shares.

A written put option on own shares and own shares — at maturity of written put the holder has a choice to either keep 100 shares or to exercise the put to receive CU100 in cash and return the shares.

The entity would need to derecognise 100 shares as the entity recognise a financial liability.
Foreign currency convertible bonds and written put options with foreign currency strike price

Convertible bond

- FCU100
- 100 shares

If conversion option is exercised

- Obligation to pay FCU100 = Liability component

A written put option on own shares and own shares

- 100 shares
- FCU100

If put option is exercised

- Obligation to deliver FCU100 = Liability component
- Obligation to exchange FCU100 for 100 shares = Derivative liability
Written puts on non-controlling interests

Questions applying IAS 32

Why gross up?

How to reclassify equity for NCI put: derecognise non-controlling interest, or recognise contra-equity account?

How to account for subsequent changes in fair value puts?

The Board’s preferred approach

Consistent classification of rights and obligations regardless of structure

For NCI puts, this means:
- Recognise a liability for the present value of the redemption amount
- Derecognise underlying NCI shares
- Classify remaining rights and obligations using derivative principle

Liability is subject to remeasurement per IFRS 9 (including effect of strike price at fair value)
Separate presentation of income and expense, if strike price = fair value of own shares
What about contingent convertible bonds?

- The potential settlement outcomes are the same as a convertible bond or a written put on own shares (i.e., either deliver a fixed number of shares or a fixed amount of cash).

- Classification would be consistent for all financial instruments with the same rights and obligations in which the entity (the issuer) does not control the settlement outcome. For example, a contingency based on the level of (regulatory) capital is considered to be outside the entity’s control.

- Consistent classification of equity component with standalone options to issue equity.

- Like IAS 32, classification considers contractual terms of financial instruments, e.g., laws and regulations are not considered to be part of the contract.
What if *the entity* has a right to choose the settlement outcome?

Reverse convertible bond
—at maturity, the *entity* has the right to choose to deliver either CU100 or 100 shares

- The reverse convertible bond does not contain a financial liability component, *unless* the bond establishes an obligation that has the feature(s) of a financial liability indirectly (see Section 8 of the DP).
- Applying the Board’s preferred approach, the entity would classify the bond as an equity instrument in its entirety.
- The Board considered but did not reach a preliminary view, about whether and if so, how the information about the entity’s right to choose to deliver cash should be provided in the financial statements.
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<thead>
<tr>
<th>Contract types and settlement types</th>
<th>IAS 32</th>
<th>The Board’s preferred approach</th>
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