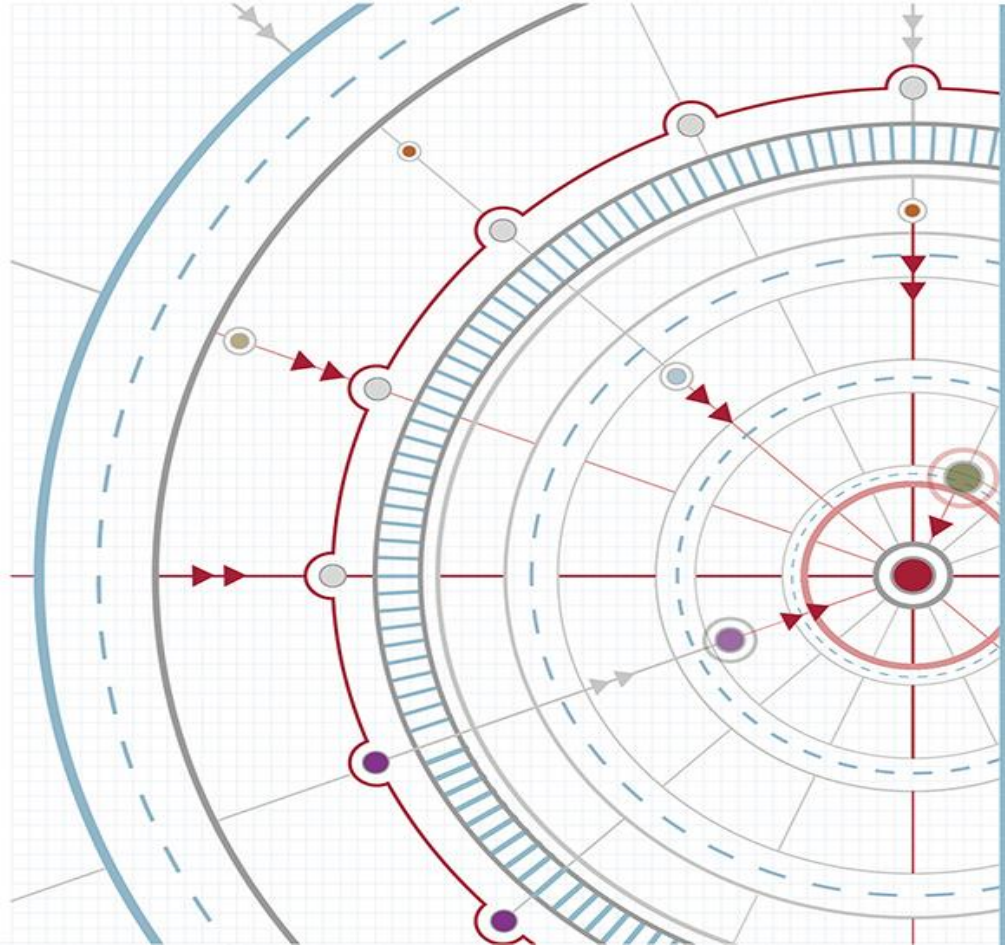
IFRS® Foundation



Financial Instruments with Characteristics of Equity

Webinar 4: Classification of compound instruments and redemption obligation arrangements

July 2018

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.

IFRS®

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

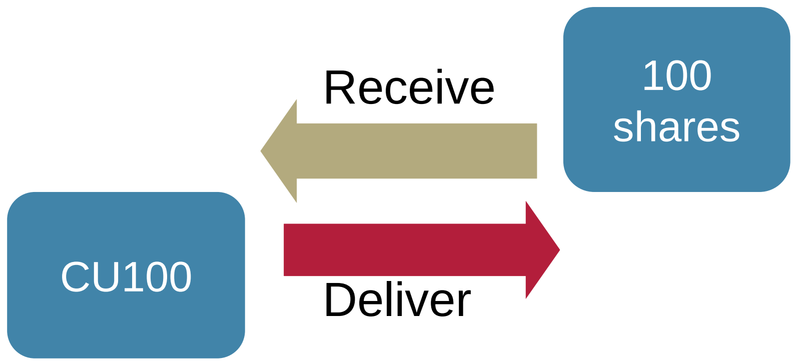
Section 5 compound instruments and redemption obligation arrangements

- 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.

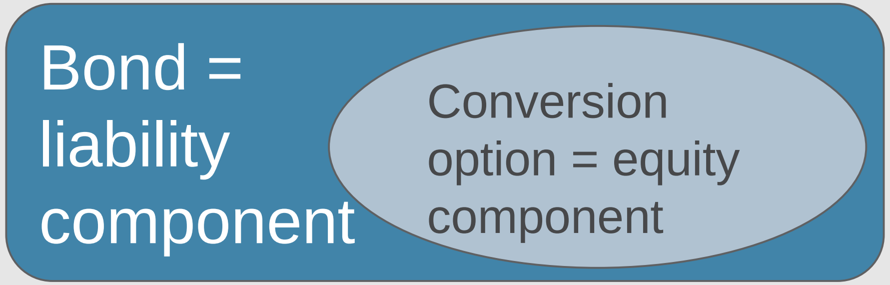
Derivatives that may require extinguishment of own equity instruments

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



- 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.

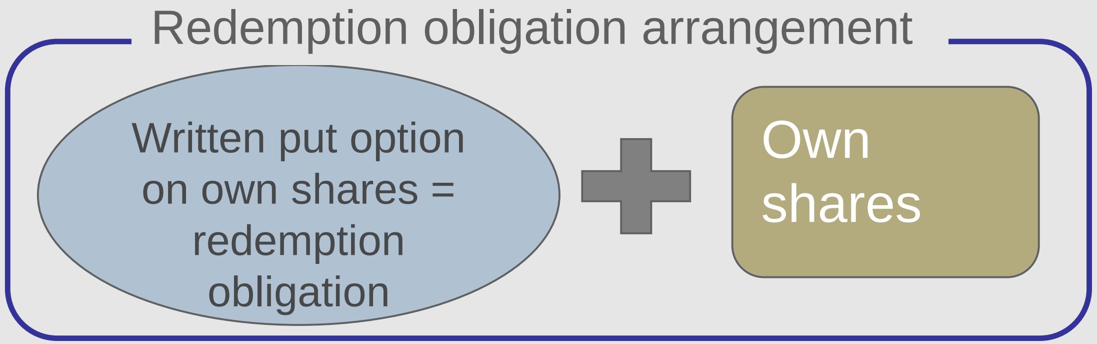
Compound instruments and redemption obligation arrangements



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 to100 shares

CU100

100 shares

If conversion option is exercised

Obligation to pay CU100 = Liability component

Obligation to exchange CU100 for 100 shares = Equity component

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

100 shares

CU100

If put option is exercised

Obligation to exchange CU100 for 100 shares = Equity component

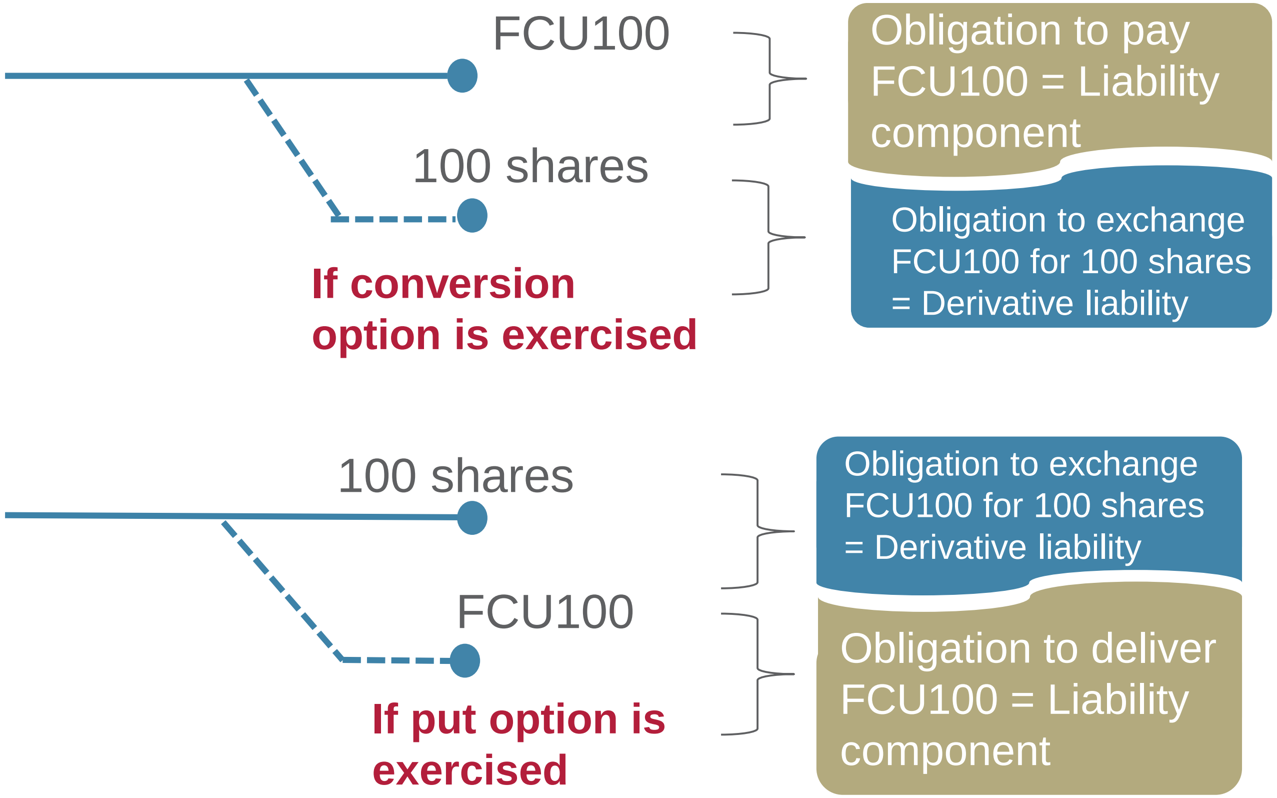
Obligation to pay CU100= Liability component

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

A written put option on own shares and own shares



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

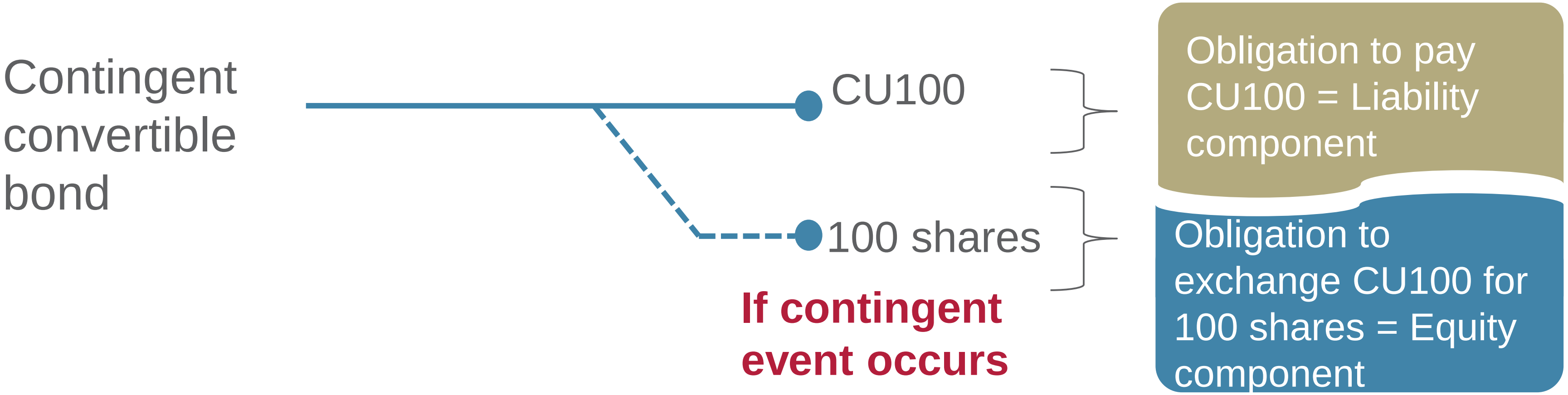
For NCI puts, this means:

- 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

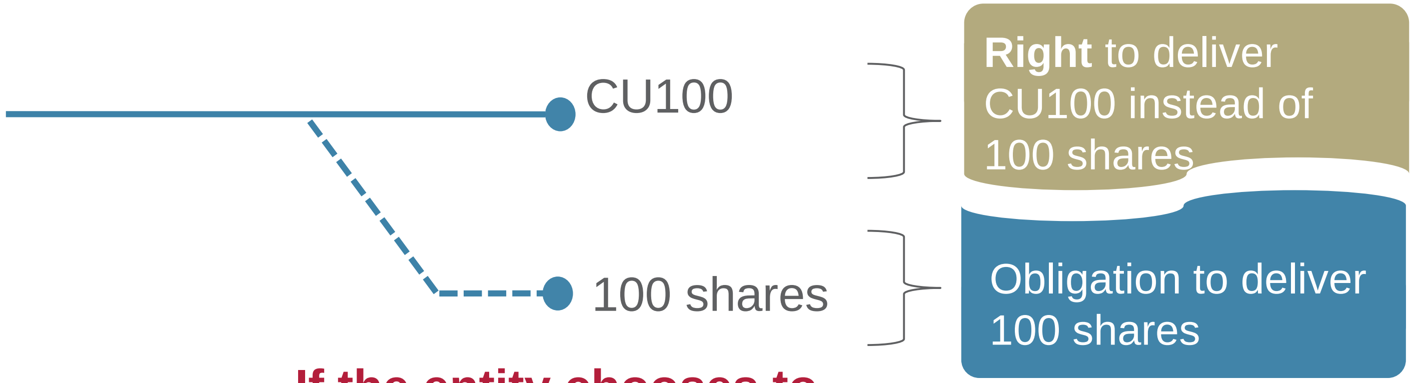
What about contingent convertible bonds?



- The potential settlement outcomes are the same as a convertible bond or a written put on own shares (ie 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, eg 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



If the entity chooses to convert the bond into 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.

IFRS

Map of derivatives-IAS 32 vs the Board's preferred approach (no independent variables)

Contract types and settlement types	IAS 32	The Board's preferred approach
Written put option on own equity (receive own equity and deliver cash, if the holder exercises)		
Net-cash settlement	Financial asset/liability	Financial asset/liability
Net-share settlement	Financial asset/liability	**Gross up: recognise a financial liability for the present value of the redemption amount, derecognise equity at the current fair value and recognise the residual (representing a written call option) in equity**
Gross physical settlement	Gross up: a financial liability for the present value of the redemption amount and reclassify from equity	Gross up: recognise a financial liability for the redemption amount, **derecognise equity at the current fair value and recognise the residual (representing a written call option) in equity**

IFRS

Map of derivatives-IAS 32 vs the Board's preferred approach (no independent variables)

Contract types and settlement types	**IAS 32**	**The Board's preferred approach**
Forward to buy own equity (receive own equity and deliver cash)		
Net-cash settlement	Financial asset/liability	Financial asset/liability
Net-share settlement	Financial asset/liability	**Gross up: a financial liability for the present value of the redemption amount and derecognise equity at the current fair value**
Gross physical settlement	Gross up: a financial liability for the present value of the redemption amount and reclassify from equity	Gross up: a financial liability for the present value of the redemption amount **and derecognise equity at the current fair value**

Financial Instruments with Characteristics of Equity – Webinar Schedule

Future webinars
Presentation of equity instruments
Presentation of financial liabilities

Contact us

Keep up to date

@IFRSFoundation

IFRS Foundation

go.ifrs.org

IFRS Foundation

Comment on our work

go.ifrs.org/comment