Financial Instruments with Characteristics of Equity

Part B
Examples
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Summary of the preliminary approach

• Step 1-Classification: Is the financial instrument a financial liability or an equity instrument?
  – Is there an obligation to transfer economic resources at particular points in time other than at liquidation?
  – Is there an obligation for a specified amount independent of the economic resources of the entity?
Summary of the preliminary approach

• Step 2-Presentation: What separate presentation requirements apply to the financial liability?
  – Separate presentation of income and expense: Does the amount of the obligation solely depend on the residual amount?
  – Separate presentation on statement of financial position: Is settlement required only at liquidation?
Summary of the preliminary approach

• Step 3-Disclosure: What disclosure requirements apply to the financial liability or equity instrument?
  – What is the priority of the claim on liquidation?
  – Does the claim result in potential dilution of ordinary shares?
Questions

For each example you are asked to answer the following questions:

1. What are the features of this financial instrument? (eg timing of transfer of economic resources, amount of the obligation, priority on liquidation, type of resources required to be transferred)

2. Is the financial instrument classified as liability or equity? (Step 1)

3. If classified as liability – does the financial instrument qualify for separate presentation of income and expense? (Step 2)

4. What features would be depicted through disclosure? How? (Step 3)
Example 1: Obligation to deliver a fixed number of ordinary shares

• An entity issues a financial instrument that will be settled by delivering 1,000 ordinary shares, which the entity is able to deliver.
Example 2: Variable share-settled bonds

• An entity issues a financial instrument that is to be settled in a variable number of the entity’s ordinary shares equal to CU1,000 on the date of settlement.
• The settlement date is 2 years after issuance.
• The financial instrument was issued for CU 800 and is subordinated to other ordinary bonds of the entity.
Example 3: Shares puttable for fair value (that do not meet ‘puttables’ exception)

• An entity issues 1,000 puttable shares.
• The puttable shares have the same rights as ordinary shares, however the holder has the additional right to put the shares back to the entity at any time.
• If the put option is exercised, the entity is required to deliver cash equal to the fair value of 1,000 ordinary shares on the date of exercise.
• The entity has other ordinary shares on issue that do not have this feature.
Example 4: Cumulative preference shares

- An entity issues 1,000 cumulative preference shares for CU1,000, each with an annual dividend of 10%.
- The entity has the right to defer dividend payments, and/or the par payment (i.e., CU1,000) indefinitely until liquidation.
- However, missed dividend payments are compounded over time at a rate of 10% until paid.
- The entity has the right to settle the claim at any time by paying the par amount and any accrued dividends.
- The preference shares are senior to the entity’s ordinary shares and non-cumulative preference shares.
Example 5: Non-cumulative preference shares

- An entity issues 1,000 non-cumulative preference shares for CU1,000, each with an annual dividend of 10%.
- The entity has the right to miss dividend payments at its sole discretion, however it cannot pay ordinary dividends without paying dividends on the preference shares.
- Missed dividend payments are not compounded.
- The non-cumulative preference shares are senior to the entity’s ordinary shares.
- At liquidation the entity pays available resources to the non-cumulative preference shares up to the par amount (ie CU1,000) before any payment to ordinary shareholders.
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<th>1. What are the features of this financial instrument? (timing, amount, priority, type)</th>
<th>2. Is the financial instrument classified as liability or equity? (Step 1)</th>
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