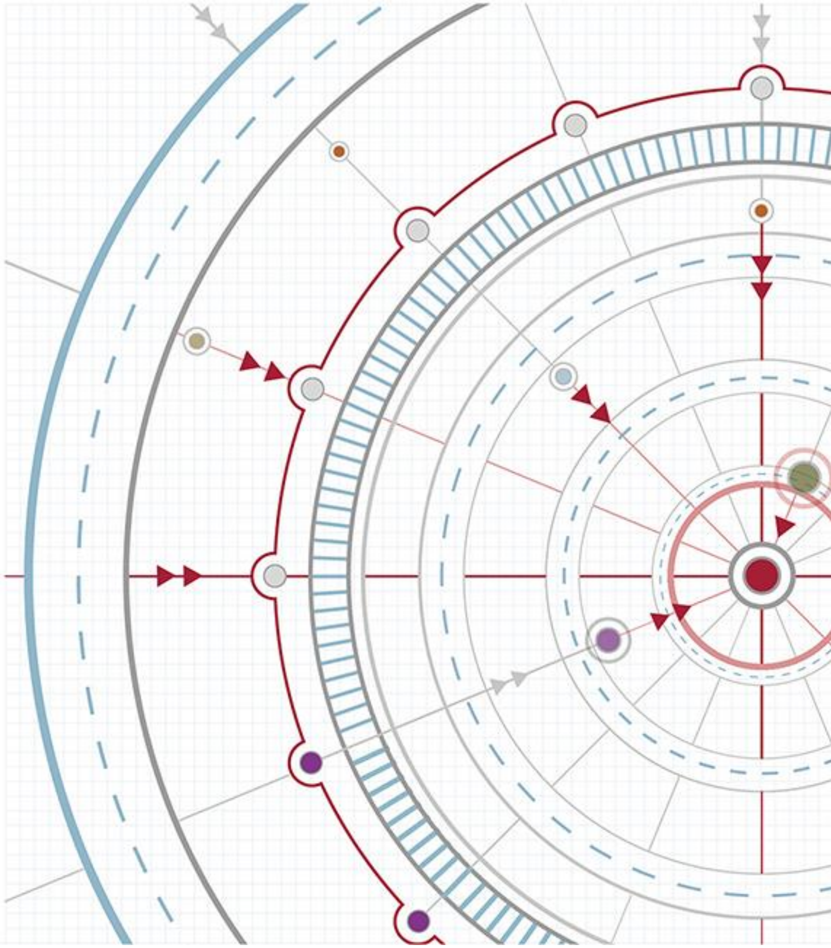

Agenda Paper 6B
Financial Instruments with Characteristics of Equity

ASAF

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What is the starting point?

IAS 32 works well for most financial instruments

- We are not starting with a blank sheet of paper, we are starting with the current requirements in IAS 32
- We are focussing on identifying and addressing challenges with existing requirements and ways to improve information provided to users of financial statements

What are the challenges?

- Difficulty applying IAS 32 to types of instruments not directly addressed by the requirements
  - Eg some instruments contingently convertible to ordinary shares
- Continuing disagreement over classification outcomes
  - FX convertible bonds, gross-up of written puts
- Why?
  - Difficulty identifying the underlying rationale of the distinction between liabilities and equity in IAS 32
  - Inconsistent use of liability definition in IAS 32 vs the *Conceptual Framework*
  - Exceptions in IAS 32 for puttable shares and FX rights issues

What are the challenges?

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

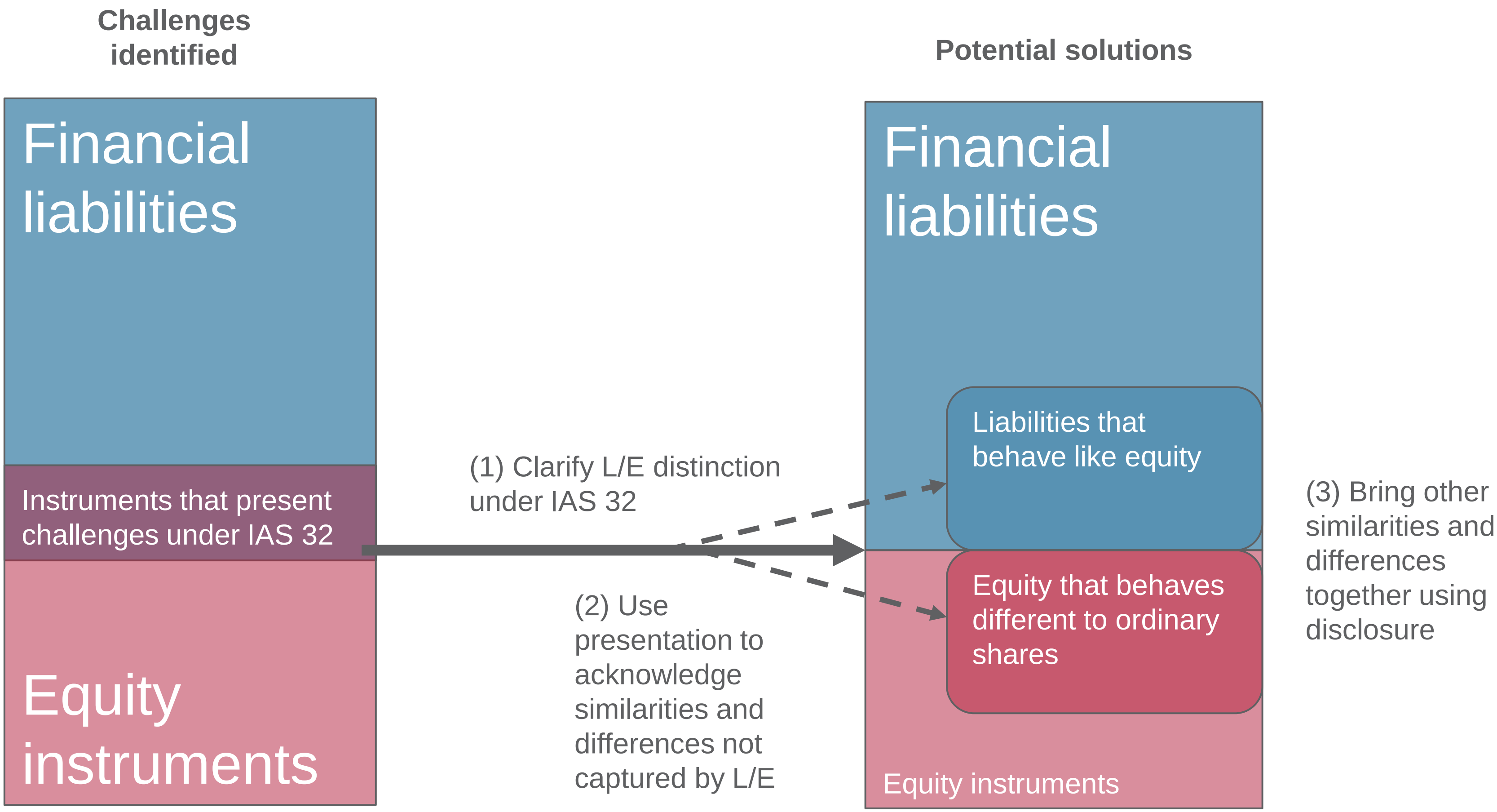
- Because classification cannot convey all similarities and differences there will always be different views about classification outcomes
  - eg variable share settled debt has a similar return to a bond, but has limited liquidity implications similar to ordinary shares
- Polarised outcomes:
  - Remeasurement and disclosure if liability classified
  - Little to no information if equity classified

How do we address the challenges?

This project is not just about classification as liabilities or equity

- To address the challenges identified, we are developing a complete package:
  - Reinforce the underlying rationale of the distinction between liabilities and equity in IAS 32
    - no big change expected to classification outcomes
  - Provide better information through presentation and disclosure
  - Improve consistency, completeness and clarity of the requirements

Overall approach



Progress made to date

- Developed three approaches to reinforce the underlying rationale of classification between liabilities and equity.
  - Board is focusing on one approach (‘gamma’). The approach is most consistent with IAS 32
  - Same approach to economic compulsion as IAS 32
- Developed presentation proposals for subclasses of liabilities and equity
- Developed discussion regarding potential disclosure
- Developed improvements to the consistency, completeness and clarity of the requirements (in particular for derivatives on own equity)

Classification

- The Board is focusing on an approach that classifies as a liability obligations:
  - 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
    - eg fixed monetary amounts regardless of settlement requirements such as variable share settled bonds
- Classification will be based on rights and obligations
- Two other approaches focussing each on only one of the above features

Presentation: Liabilities

- Separate presentation requirements for those liabilities that have one feature but not the other
  - For obligations classified as liabilities, but for which the amount of the obligation depends on share price (eg shares redeemable at fair value, fixed-for-fixed derivatives that are net cash settled), present gains and losses separately in other comprehensive income.
  - For foreign currency fixed-for-fixed derivatives (eg conversion option in FX convertible), apply similar separate presentation requirements under particular circumstances.

Presentation: Equity

- The Board is considering separate presentation requirements for equity claims other than ordinary shares (similar to non-controlling interest)
  - Attribute profit or loss and other comprehensive income
  - Update carrying amounts
- Benefits of doing so:
  - Provide more information about various classes of equity (currently only provided through EPS which has limitations)
  - Reduce consequences of classification decisions (ie currently limited information is required for different equity instruments)
- Use existing requirements in EPS for non-derivatives
- The Board is considering costs and benefits of different approaches to attribution for derivatives (eg fair value)

Disclosure

- The Discussion Paper will include a discussion of the following potential disclosures :
  - the priority of claims on liquidation;
  - the potential dilution of ordinary shares; and
  - additional supporting information about the presentation and classification requirements of the Gamma approach.

Illustrative classification outcomes

	IAS 32	Proposed approach (Gamma)
Ordinary bonds	Liability	Liability
Ordinary shares	Equity	Equity
Shares redeemable for fair value	Liability	Liability with separate presentation in statement of comprehensive income
Variable share-settled bonds	Liability	Liability
Obligation to deliver a fixed number of shares	Equity	Equity
FX rights issue (that meets exception under IAS 32)	Equity	Liability (with separate presentation in statement of comprehensive income under particular circumstances)
FX conversion option (into fixed shares)	Liability	Liability (with separate presentation in statement of comprehensive income under particular circumstances)

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Next steps

- Future discussions with the Board will include:
  - substance of rights and obligations in contracts and the interaction with legal and regulatory requirements
  - further consideration of improvements to consistency, completeness and clarity of existing requirements in IAS 32

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