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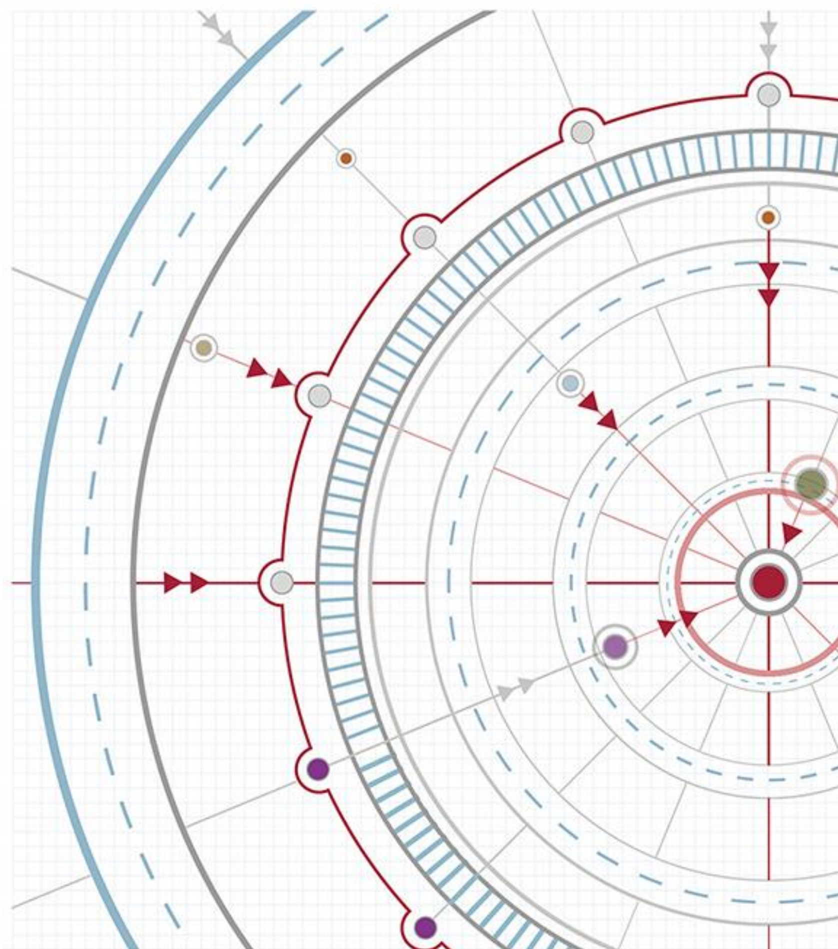

Agenda Paper 6
Financial Instruments with Characteristics of Equity

Accounting Standards Advisory Forum meeting
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ASAF agenda paper 6

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Objective of this session

- In this session we illustrate some of the practical implications of the approach that will be included in the forthcoming Discussion Paper on the Financial Instruments with Characteristics of Equity (FICE) project
- We have included examples of instruments that will have different classification or presentation based on that model compared to IAS 32 *Financial Instruments: Presentation*
- We would like your input on the examples to help us in developing the Discussion Paper

Questions

- Do the examples demonstrate the application of the approach to be included in the Discussion Paper?
- Do you have any other suggestions to make the examples more useful?

What are the potential practical implications?

- One of the objectives of the FICE research project is to identify and clarify the underlying rationale of the distinction between liabilities and equity in IAS 32
- Identifying the underlying rationale has involved debating matters such as:
  - why obligations to deliver a variable number of shares should be liabilities
  - why put options written on equity instruments should be ‘grossed up’
- Identifying the underlying rationale is unlikely to change the classification outcomes for most claims, however some classification outcomes might change because of refinements to the underlying rationale
- The Board will decide whether to undertake any further work based on feedback on the Discussion Paper

What are the potential practical implications?

- Another objective of the project is to develop presentation and disclosure requirements to provide information about other features of claims irrespective of whether the claims are classified as liabilities or equity.
- The last objective of the project is to improve the consistency, clarity and completeness of the requirements to address some practical matters that arise when applying IAS 32.
- Improving the requirements should help address known diversity in practice, in particular for those issues that have been submitted to the Interpretations Committee and remain unresolved, including:
  - Developing additional guidance to help judge whether particular variables violate the classification principles for derivatives.
  - Developing additional guidance for accounting for written put options.

Illustrative examples of some potential changes

- Example 1-Foreign currency
- Example 2-Shares redeemable at fair value
- Example 3-Written puts on own equity
- Example 4-Cumulative preference shares

- Appendix A includes a summary of the features used for classification and presentation when applying the approach to be included in the Discussion Paper

Example 1: Foreign currency

- An entity enters into a derivative contract to receive a fixed amount of foreign currency units (FCU) in exchange for delivering a fixed number of equity instruments
  - Eg a written option to deliver 100 shares in exchange for FCU100.
- **Situation today under IAS 32:**
  - If a derivative contract meets the 'foreign currency rights issue exception' then it is classified as equity
  - IAS 32 classifies other 'fixed foreign currency-for-fixed number of share' derivatives, including conversion options embedded in foreign currency convertible bonds, as liabilities
- **Under the approach to be included in the Discussion Paper:**
  - Classify both of the above consistently as liabilities, however apply separate presentation requirements under certain circumstances, eg if:
    - only variable, other than share price, is foreign currency
    - the variable is not leveraged
    - precluded from issuing same instrument with strike price denominated in local currency
  - Above would apply to standalone options and embedded options that are separated from the host contracts (eg conversion options)

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Example 2: Shares redeemable for fair value

- An entity issues instruments with features that are otherwise equivalent to ordinary shares, however the entity is also obliged to redeem them, on demand, in exchange for cash equal to the fair value of the shares:
  - Cash payment requirement at time other than at liquidation is similar to ordinary bonds
  - However, changes in the amount (hence returns) are similar to ordinary shares
- The entity has other ordinary shares on issue that do not have this feature, therefore these instruments do not meet the puttable exception in IAS 32.
- **Situation today under IAS 32:**
  - IAS 32 classifies puttable shares as liabilities because of the obligation to transfer cash, unless they meet the puttables exception
  - Gains and losses are income and expense
- **Under the approach to be included in the Discussion Paper:**
  - Classify as liabilities
  - Gains and losses are income and expense, however apply separate presentation requirements (ie present in OCI) because they depend solely on the residual amount (ie the share price)

Example 3: Written put options on own equity

- The entity enters into a contract that obliges it to redeem a fixed number of its own ordinary shares, in exchange for a fixed amount of cash which is exercisable by the holder in 3 years
  - Eg a written option to redeem 100 shares in exchange for CU100 in three years
- **Situation today under IAS 32:**
  - IAS 32 requires an entity to recognise a liability for the present value of the redemption amount, this amount is reclassified from equity
  - Questions around subsequent measurement, and the accounting within equity (which account should be debited when reclassifying from equity)
- **Under the approach to be included in the Discussion Paper:**
  - recognise a liability for the present value of the redemption amount
  - changes in the liability are income and expense, the specified amount of the redemption obligation does not meet the separate presentation requirements, therefore they are presented in profit or loss
  - the Board is considering additional guidance about the accounting within equity in February 2017

Example 4: Non-redeemable cumulative preference shares

- An entity issues an instrument that obliges it to pay interest per annum on a fixed principal amount, however the entity has the right to defer payments indefinitely. Any payments deferred are compounded over time.
  - Eg instrument that obliges the entity to pay 6% per annum on CU100, with a right to defer payment, but deferred payments are compounded annually
- **Situation today under IAS 32:**
  - Classified as equity, because the entity has the unconditional right to avoid transferring cash or another financial asset.
  - However, if the obligation requires settlement by transferring a variable number of shares equal to the amount of the obligation, then it would be a liability even though the entity is not required to transfer cash or another financial asset.
- **Under the approach to be included in the Discussion Paper:**
  - Classify all obligations for a specified amount independent of the entity's economic resources consistently as liabilities because changes in the amount (hence returns) are similar to ordinary bonds
  - Separate presentation in the statement of financial position to signal that these liabilities have a low order of liquidity

Appendix A
Features used for classification and presentation

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Classification

- The approach to be included in the Discussion Paper 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); or
  - 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).
- Claims that do not have either of the two features will be classified as equity

Presentation

- The approach to be included in the Discussion Paper requires separate presentation for those liabilities that have one feature used for classification but not the other, including:
  - 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.

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