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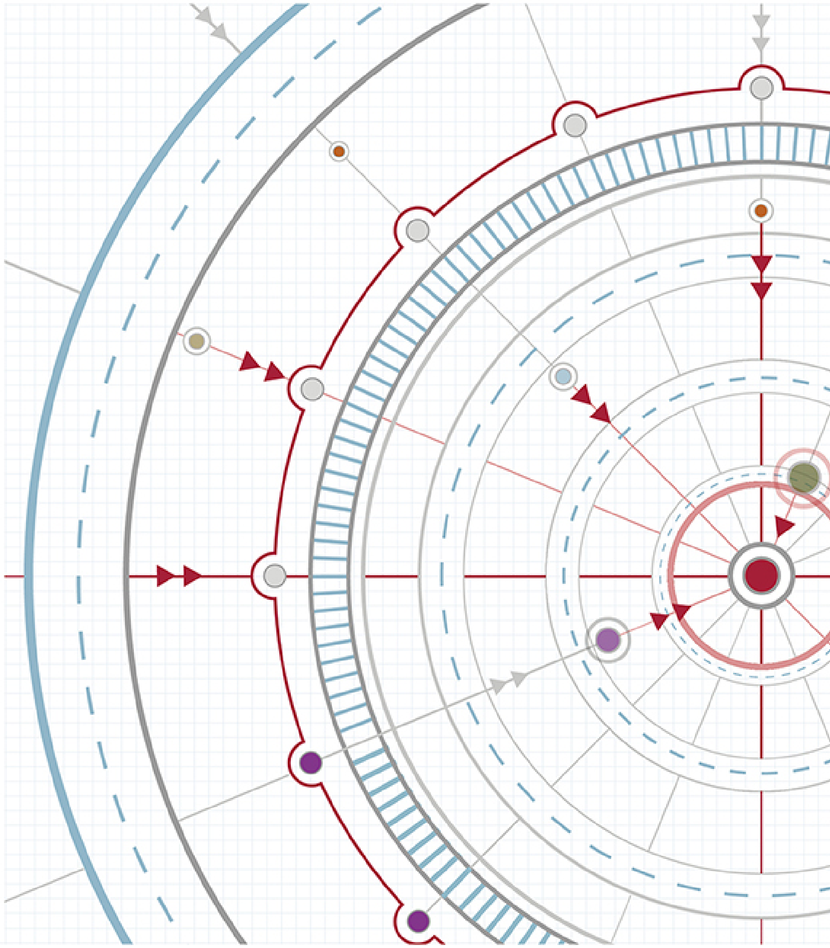

GPF meeting, 6 November 2018
Agenda Paper 5

Financial Instruments with Characteristics of Equity

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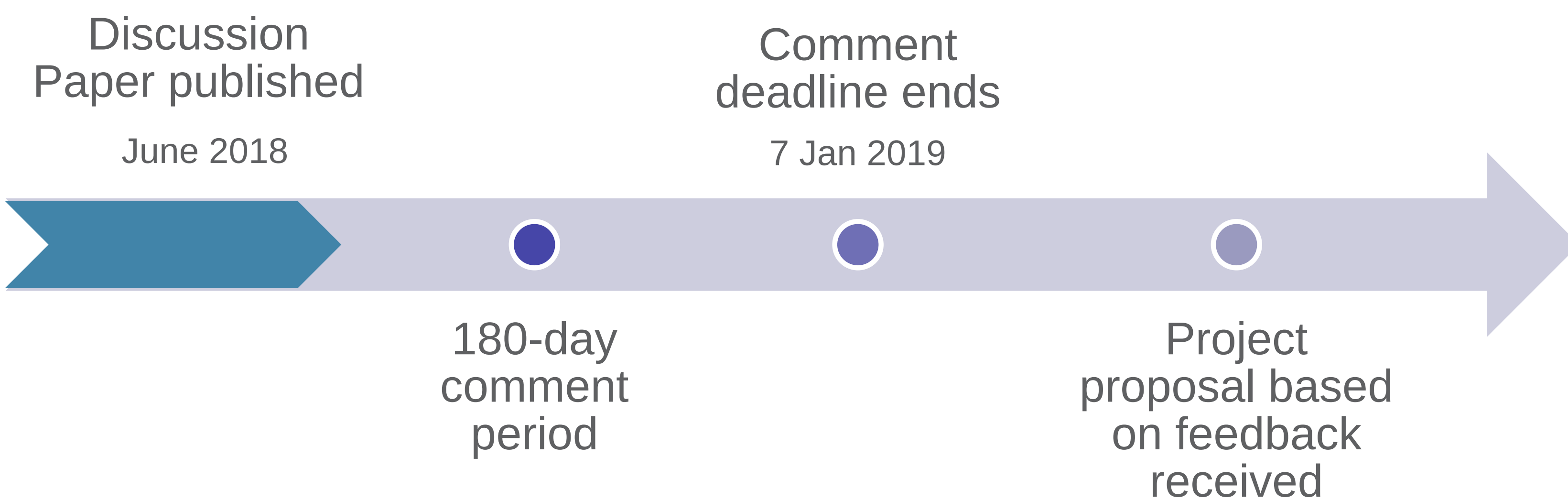
Purpose of this session

- The IASB staff will provide an overview of the key proposals of the Discussion Paper *Financial Instruments with Characteristics of Equity.*
- The staff would also like to seek any initial comments GPF members may have on the proposals.

About the project

- Research project
- Project objectives
  - improve the information that entities provide in their financial statements about financial instruments that they have issued
  - address challenges with applying IAS 32 in practice



More information can be found on the FICE project page on our website.
https://www.ifrs.org/projects/work-plan/financial-instruments-with-characteristics-of-equity/

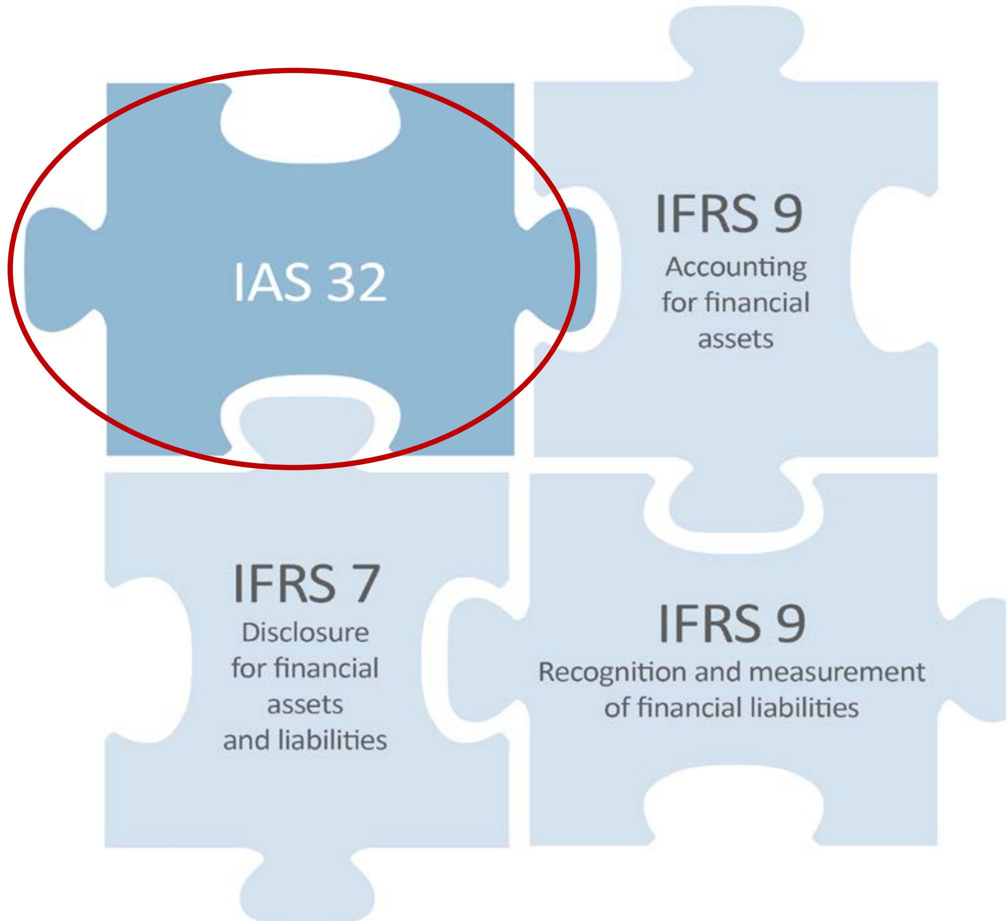
Project scope

In scope

- Classification of financial instruments as financial liabilities or equity instruments
  - issuer perspective

Not in scope

- Recognition and measurement requirements in IFRS 9
- Reconsidering disclosure requirements for financial assets and liabilities in IFRS 7



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What would not change?

The Board would carry forward some existing requirements largely unaltered. For example:

- the definition of a financial instrument
- the ‘puttables exception’ in IAS 32
- the conclusions in IFRIC 2
- the way in which classification would (or would not) be affected by economic compulsion and laws and regulation

What have we heard?

IAS 32 works well for most financial instruments

But financial innovation since IAS 32 was issued has resulted in challenges with applying it to a growing number of complex financial instruments

Continuing debate about the underlying rationale of the distinction between liabilities and equity

Limited information provided for equity instruments

How are we addressing them?

- Articulate the principles for the classification with a clear rationale

- Improve the consistency, completeness and clarity of the requirements

- Enhance presentation and disclosure requirements about financial liabilities and equity instruments

Classification principles with a clear rationale

Classification: the basic idea is…

A financial instrument issued by an entity is a financial liability if the answer is yes to one or both of the following questions

Can the issuer be required to pay cash or to hand over another financial asset before liquidation?

Timing feature

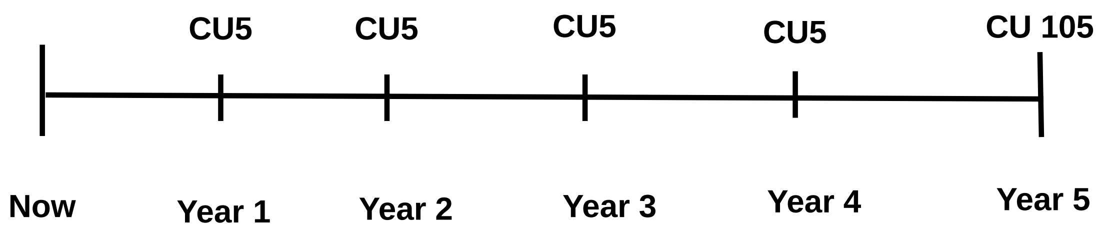
Has the issuer promised a return to the instrument's holder regardless of the issuer's own performance or share price?

Amount feature

Otherwise, it is an equity instrument

Example #1

- Issue an instrument for CU100
- Coupon of CU5 due each year and repayment of CU100 due at year 5



Should it be classified as liability or equity?	
Timing Feature	Any obligation to transfer cash before liquidation? ✓
Amount Feature	Return on instrument independent? ✓

Classified as a financial liability

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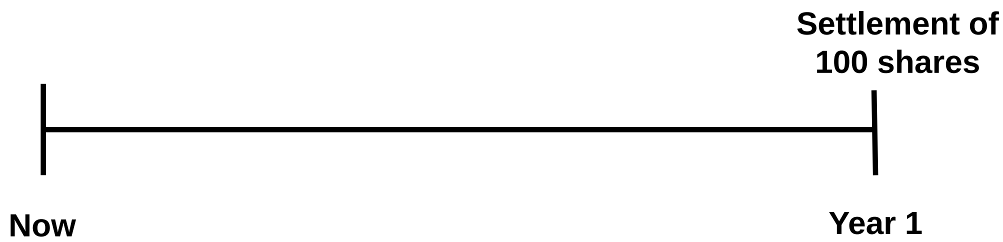
Example #2

- **Issue an instrument for CU100**
- **Obligation to deliver 100 units of own shares at year 1**

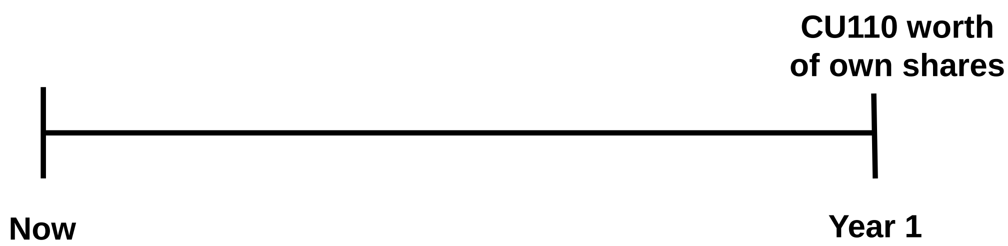


Should it be classified as liability or equity?		
Timing Feature	Any obligation to transfer cash before liquidation?	✗
Amount Feature	Return on instrument independent?	✗

Classified as equity

Example #3

- Issue an instrument for CU100
- Obligation to deliver own shares worth CU110 at year 1

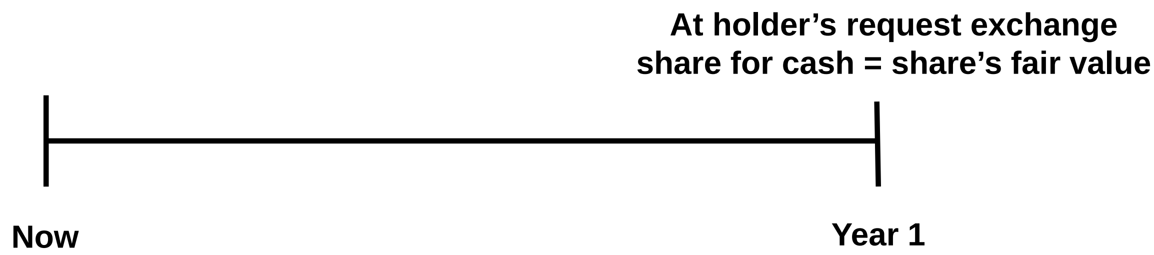


Should it be classified as liability or equity?	
Timing Feature	Any obligation to transfer cash before liquidation?
Amount Feature	Return on instrument independent?

Classified as a financial liability

Example #4

- **Issue a share with the same rights as an ordinary share BUT agree to redeem the shares in cash at the holder's option at year 1 for its fair value**



Should it be classified as liability or equity?		
Timing Feature	Any obligation to transfer cash before liquidation?	✓
Amount Feature	Return on instrument independent?	✗

Classified as a financial liability

Classification outcomes

Amount feature / Timing feature	Contains obligation for <u>an amount independent</u> of the entity's available economic resources	Contains <u>no</u> obligation for an amount independent of the entity's available economic resources
Obligation to transfer economic resources required at a specified time other than at liquidation	**Liability**	**Liability**
Obligation to transfer economic resources required <u>only at liquidation</u>	**Liability**	**Equity**

Improve the consistency, completeness and clarity of the classification requirements

Classification of derivatives: own equity

Application challenges when applying IAS 32	The Board's preferred approach

What does 'fixed' mean in the 'fixed-for-fixed' condition?

Why is there inconsistency between classification of foreign currency options?

Classification principle that applies consistently to derivatives in their entirety

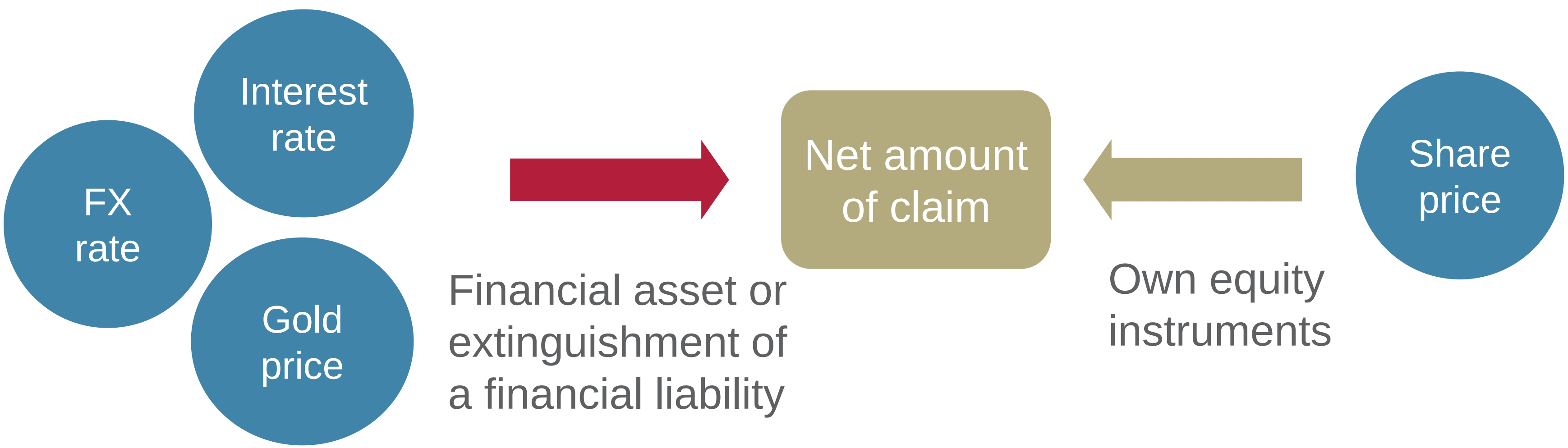
- Tests whether net amount is affected by any "independent variables" - fixed-for-fixed derivatives will continue to be equity
- Principle would clarify that some variables do not preclude equity classification (eg some anti-dilution provisions)

Classification of derivatives: variables

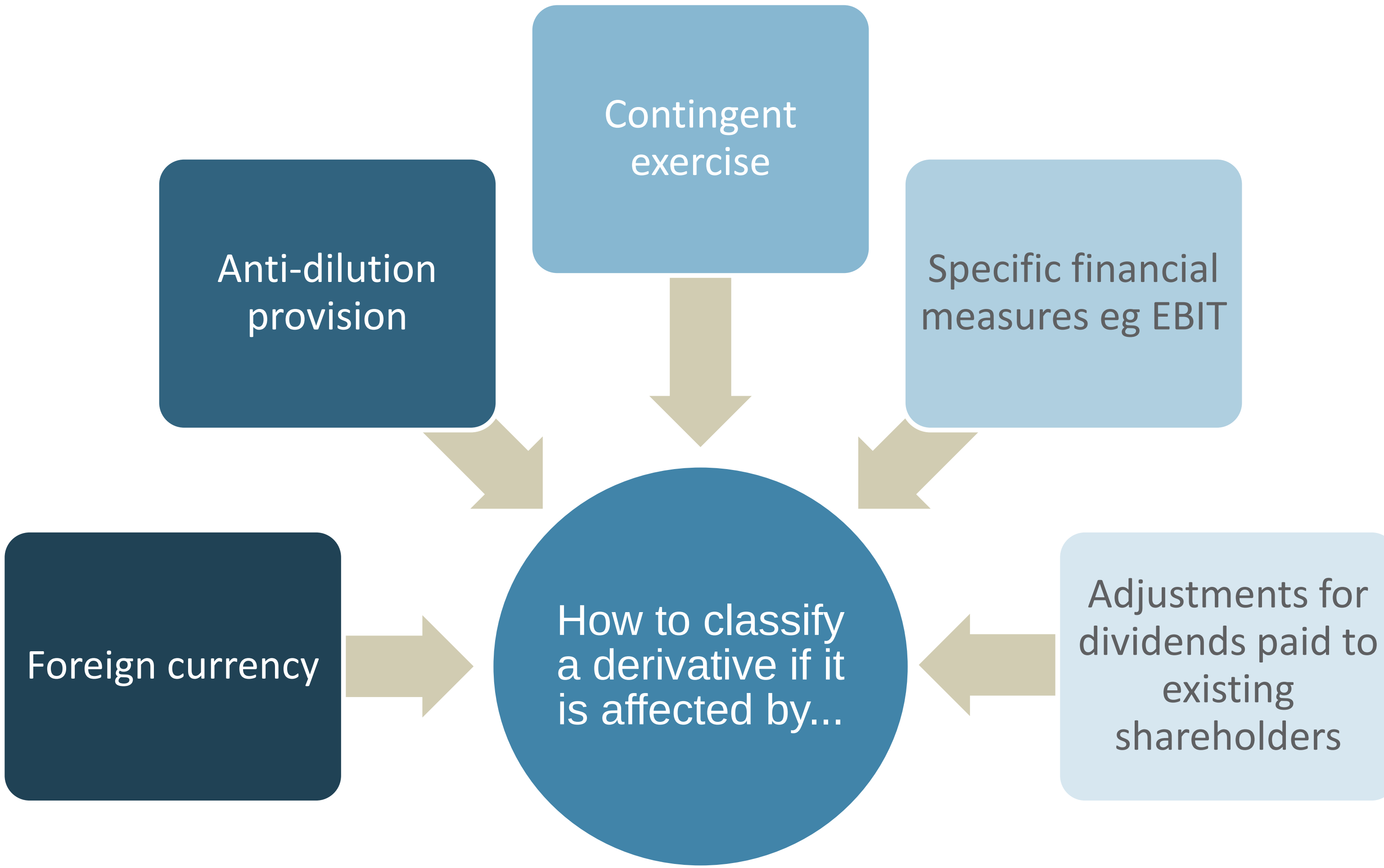
The Board's preferred approach would classify a derivative on own equity as a financial asset or a financial liability if:

(a) it is net-cash settled (the 'timing' feature); and/or

(b) the net amount of the derivative is affected by a variable that is independent of the entity's available economic resources (the 'amount' feature).



Examples of variables



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 redemption amount
- Derecognise underlying NCI shares at their fair value at the date the put options are issued
- Classify remaining rights and obligations using derivative principle

If strike price is at fair value:

- Remeasure liability
- Separate presentation of income and expense

Presentation and disclosure

Presentation - financial liabilities

Challenges when applying IAS 32	The Board's preferred approach
There are a variety of financial liabilities with different features	Distinguish some financial liabilities using separate presentation in the statements of financial position and financial performance
Changes in liabilities linked to own share price are arguably not relevant for an entity's performance	Present separately in OCI income and expenses arising from some financial liabilities: • those that contains no obligation for an amount that is 'independent' • some FX derivatives on own equity subject to specific conditions

Presentation - financial liabilities (2)

Does the return on the financial liability behave like the return on an equity instrument (ie the amount is not 'independent')?

NO

Profit or Loss	
Income and expenses from financial liabilities that have debt-like return	X/(X)
Profit	XXX

YES

Statement of other comprehensive income	
Income and expenses from financial liabilities that have equity-like return	X/(X)
Total comprehensive income	XXX

No recycling to profit or loss

Presentation – equity instruments

Step 1: Start with profit or loss and OCI

Step 2: Non-derivative equity instruments

Present the amount of dividends (the amount required to be adjusted for when calculating basic EPS in accordance with IAS 33)

Step 3: Derivative equity instruments

Present income and expenses attributable to derivative equity instruments using one of possible methods (see appendix for further detail)

No preliminary view formed on methods

Step 4: ordinary shares

Present the remaining income and expenses attributable to ordinary shares

Disclosures

The Discussion Paper explores possible requirements to disclose:

- the priority of claims on liquidation (eg table to the right)
- the potential dilution of ordinary shares
- terms and conditions that are relevant to understanding of the timing or the amount feature

Order of Priority	As of 1 January 20XX In CU million
Senior Secured Loan	X
Junior Secured Loan	X
Subordinated notes	X
Total Liabilities	**XX**
Non-cumulative preference shares	X
Ordinary shares	X
Total Equity	**XX**
Total Capitalisation	**XXX**

The Board is seeking feedback on the costs and benefits of disclosure of this information

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Other issues covered

Economic compulsion	Law and regulation	Existing exceptions
• Retain IAS 32 approach • No intent/probability overlay	• Classification based on terms of contract only • Retain the provisions in IFRIC 2 (co-operative shares)	• “Puttables” – keep without change • Foreign currency rights issue – would be liability but separate presentation in OCI of changes subject to specific criteria

Appendix: approaches to attribution

Full fair value approach	Average-of-period approach	End-of-period approach
Attribute total comprehensive income to derivative equity instruments based on changes in their fair value. Investors will get the same information about **changes in fair value of all derivatives on own equity** as if they are classified as financial assets or financial liabilities.	Use the average-of-period fair value ratio to apportion the entity's total comprehensive income for the period. Investors will get information similar to **diluted earnings per share** applying IAS 33.	Reallocate the end-of-period carrying amount of equity among the various derivative equity instruments and ordinary shares so as to reflect the end-of-period fair value ratio. This approach might better depict the **relative carrying amounts** of the different components of equity at the end of the period than the other approaches.

Or
Disclosure only

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