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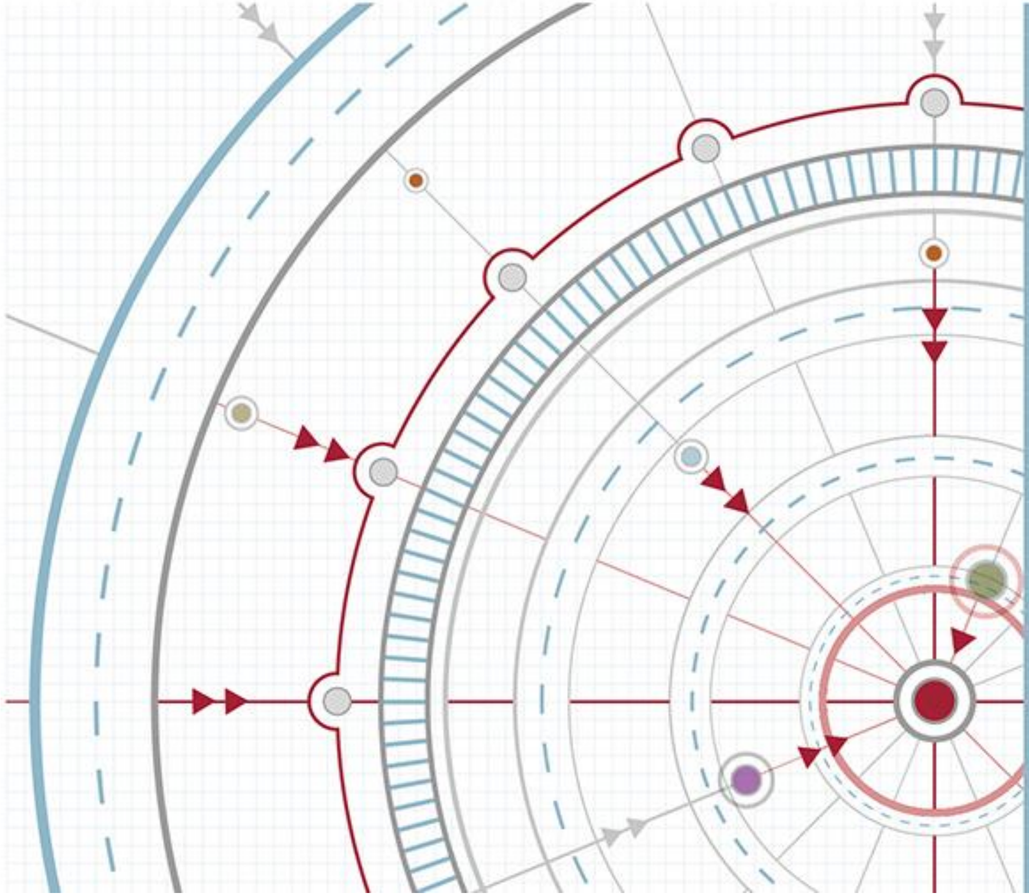

Emerging Economies Group
October 2018

Agenda Paper 1

Financial Instruments with Characteristics of Equity

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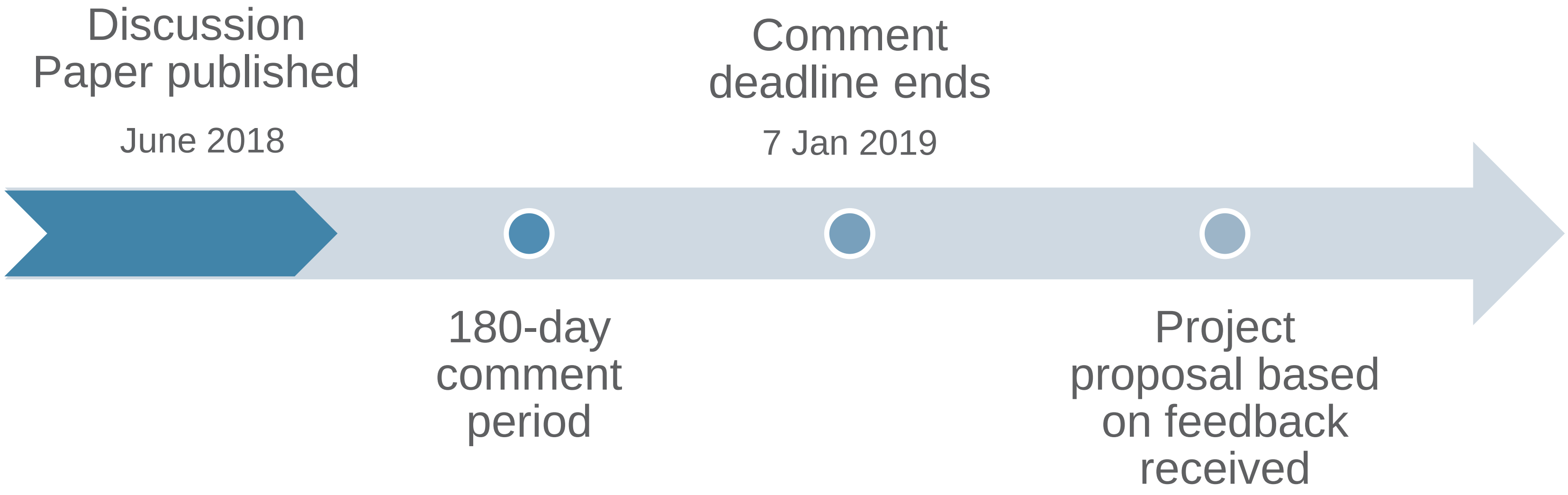
Why is the Board undertaking the project?

When a company issues a financial instrument, the company (issuer) classifies it as either a liability or as equity in its financial statements.

- This distinction is important because the classification of the instrument affects how the issuer’s financial position and performance are depicted, and consequently investors’ assessments of their financial position and performance.
- For example, changes in the carrying amount of a financial liability would be recorded in profit or loss whereas changes in equity would not.

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 *Financial Instruments: Presentation* 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/

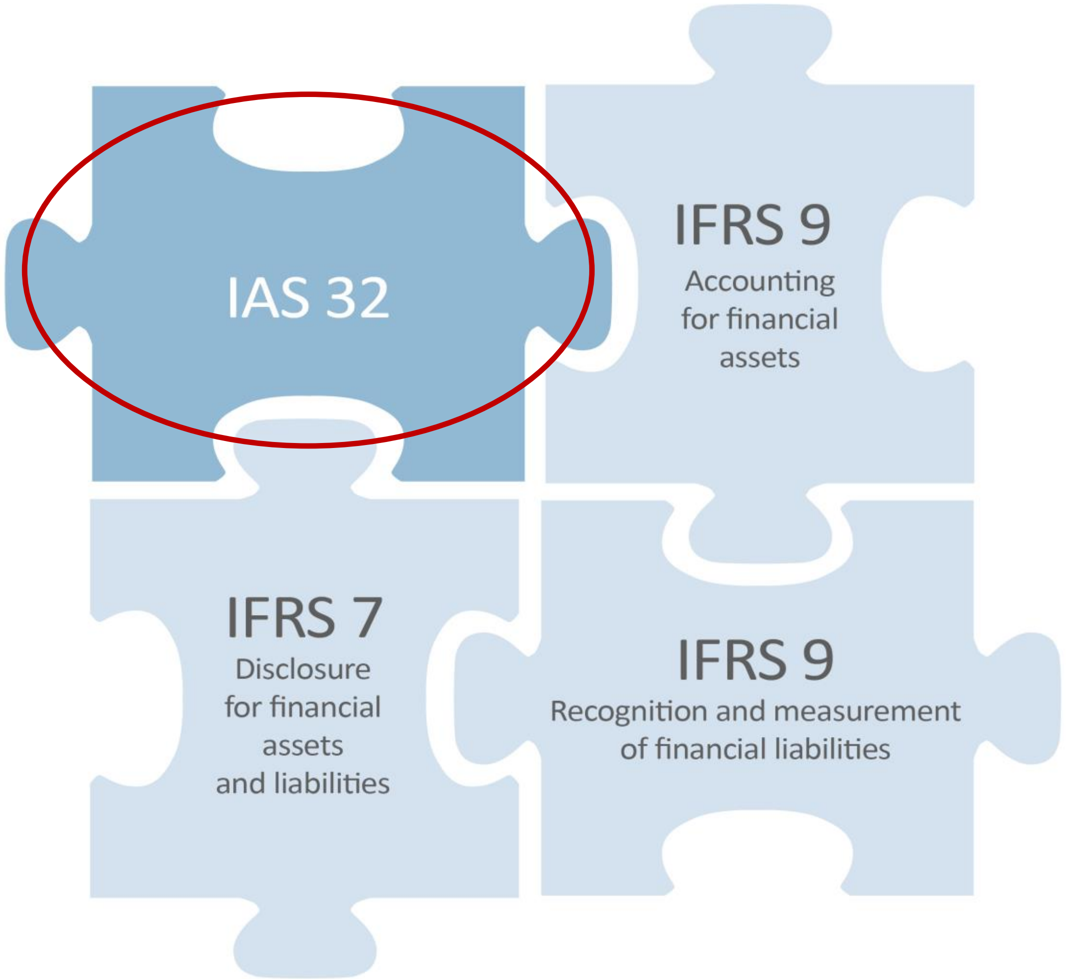
Project scope

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 the existing disclosure requirements for financial assets and liabilities in IFRS 7



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Section 1 Objective, scope and challenges

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

Resulting in application challenges and accounting diversity in practice.

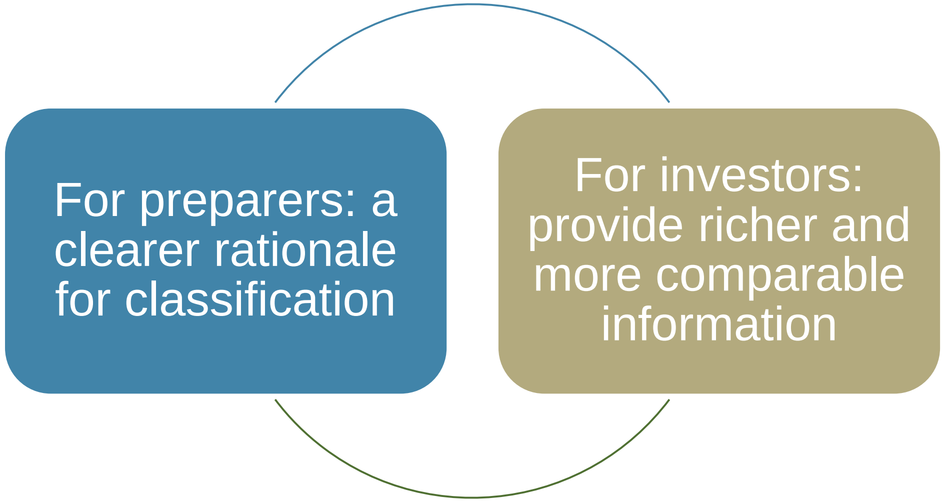
Diversity makes it difficult for investors to assess how these financial instruments affect companies' financial position and performance.

What are the causes of the problems?

Causes	How are we addressing them?
No clear rationale for the classification requirements	• Articulate the principles for the classification with a clear rationale • Improve the consistency, completeness and clarity of the requirements
Classification can only tell part of the story	• Enhance presentation and disclosure requirements about financial liabilities and equity instruments

What will be the impact?

- The Board is seeking to limit unnecessary changes to classification outcomes of IAS 32.
- Most simple instruments: no change of classification
- More complex instruments: also few changes in classification, but



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

Structure of the Discussion Paper

Sections	Title
1	Objective, scope and challenges
2	The Board's preferred approach
3	Classification of non-derivative financial instruments
4	Classification of derivative financial instruments
5	Compound instruments and redemption obligation arrangements
6	Presentation
7	Disclosure
8	Contractual terms

Section 2 Overview of the Board’s preferred approach

What analyses are users trying to do?

Funding liquidity and cash flows (Timing feature)

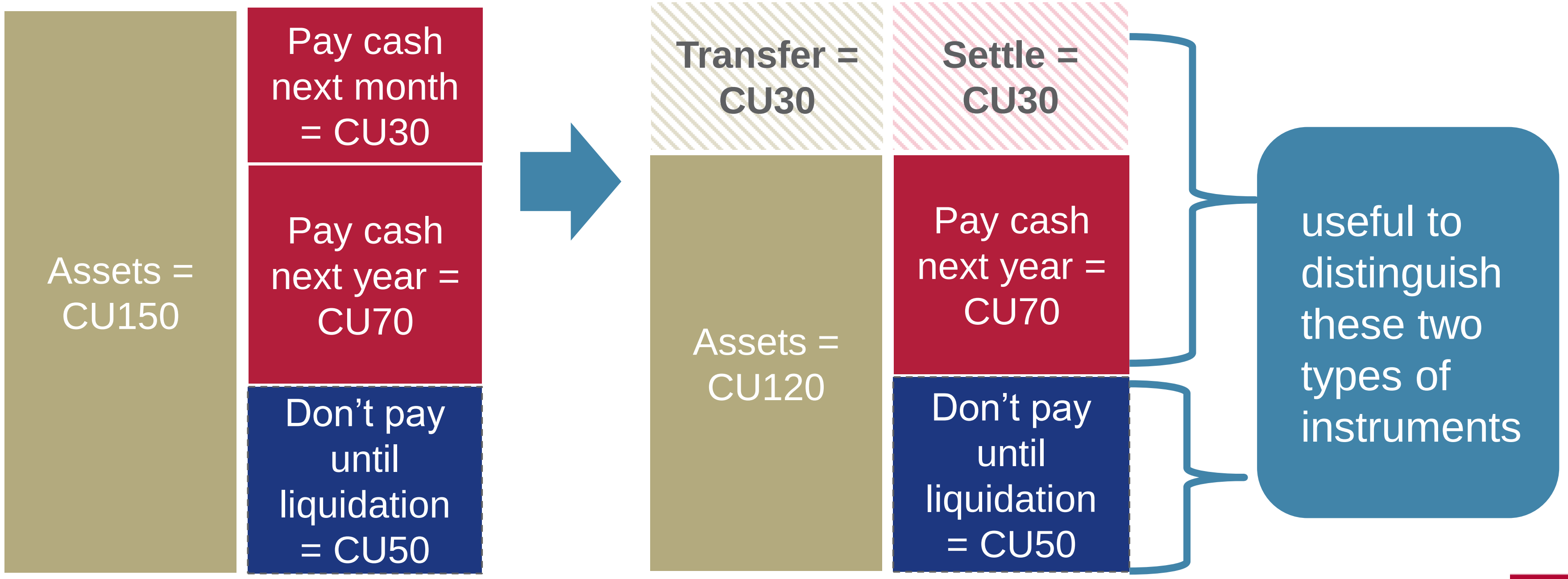
- Depends on information about an entity's obligations to transfer cash or other financial assets at particular points in time

Balance-sheet solvency and returns (Amount feature)

- Depends on information about the AMOUNT of an entity's obligations at particular points in time and
- Whether the entity has produced a sufficient return to satisfy its promised payments

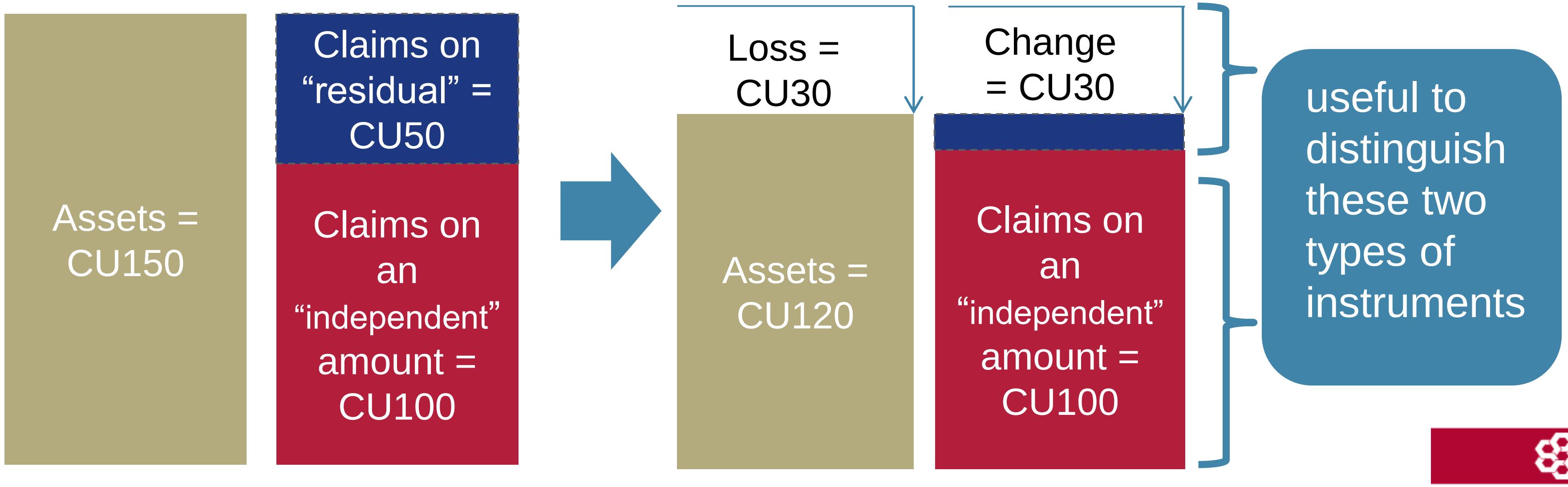
Underlying rationale

- **Timing feature** is relevant to the **assessments of funding liquidity and cash flows**:
  – whether the entity has sufficient economic resources to meet its obligations as and when they fall due
  – liquidity analysis (eg current ratio and quick ratio)



Underlying rationale (cont.)

- **Amount feature** is relevant to the **assessments of balance-sheet solvency and returns**:
  - whether the entity has sufficient economic resources to meet its obligations at a point in time and whether it has produced a sufficient return to satisfy the claims against the entity
  - how claims respond to gains/losses on economic resources
  - financial leverage and flexibility (eg interest coverage, leverage ratio)



Classification: the basic idea is…

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

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

Timing feature

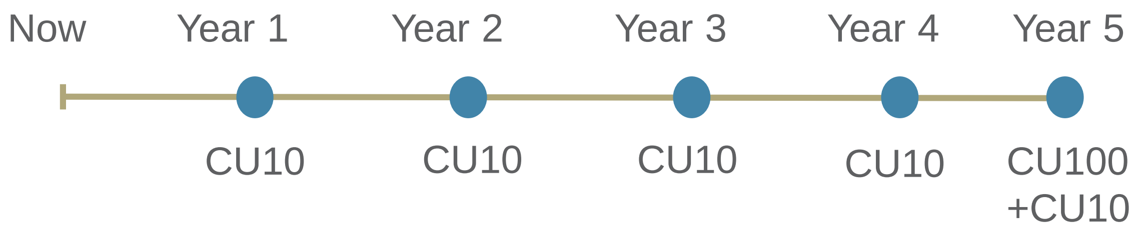
Has the issuer promised a return to the instrument's holder regardless of the issuer's own performance or share price?

Amount feature

Otherwise, it is an <u>**equity**</u> instrument

Example #1

An entity issues an instrument for CU100 today, the instrument contains an obligation to pay a coupon of CU10 for 5 years and repay the principal amount of CU100 at the end of 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

Example #2

An entity issues an instrument for CU100 today, the instrument contains an obligation to issue 110 own shares in 1 year.

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

An entity sells 1 share for CU100 today and agrees to buyback the share in 1 year for CU110.

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

An entity issues an instrument for CU100 today, the instrument contains an obligation to issue a variable number of shares with a total value equal to CU110.

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 #5

An entity issues a share for CU100 today, the share contains an obligation to buy back the share in 1 year for its market price in cash.

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 #6

An entity issues an instrument for CU100 today, the instrument has to be redeemed for cash in 1 year at a value equal to 30% of the total assets of the entity at that point in time.

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

The Board's preferred approach

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

Some examples

Amount feature / Timing feature	Contains obligation for an amount independent of the entity's available economic resources	Contains no obligation for an amount independent of the entity's available economic resources
Obligation to transfer of economic resources required at a specified time other than at liquidation	Bonds, loans	Shares puttable at fair value*
Obligation to transfer of economic resources required only at liquidation	Share-settled debt, cumulative prefs	Ordinary shares, vanilla warrants

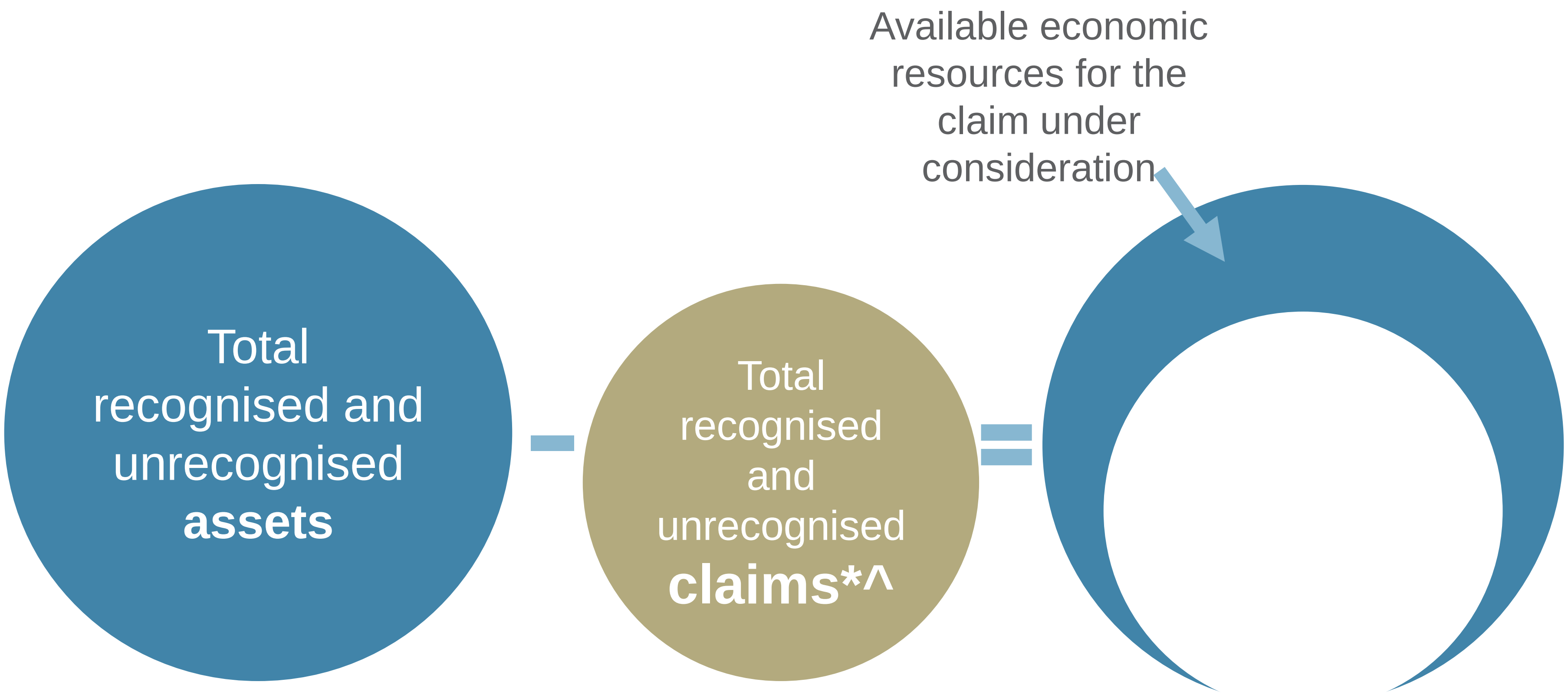
*That do not meet the puttable exception.
No proposals to change the existing puttable exception.

The Board's preferred approach

- Some liabilities will have features that are relevant for one but not the other assessment
  - for these liabilities the board considered providing information through separate presentation
- For features that are not captured through classification, the Board considered separate presentation and disclosure requirements to provide better information about
  - Equity instruments
  - Dilution and priority

Section 3 Application of the Board's preferred approach to non-derivative financial instruments

Available economic resources?



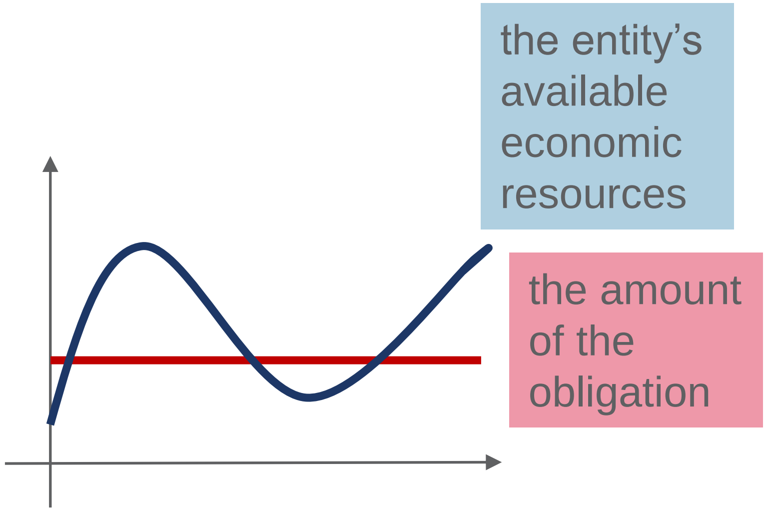
*Claims include all liabilities and equity instruments of the entity
^except for the financial instrument in question

Amount independent of available economic resources

- An amount is independent of the entity's available economic resources if:
  - the amount does not change as a result of changes in the entity's available economic resources; or
  - the amount changes as a result of changes in the entity's available economic resources but does so in such a way that the amount could exceed the available economic resources of the entity.

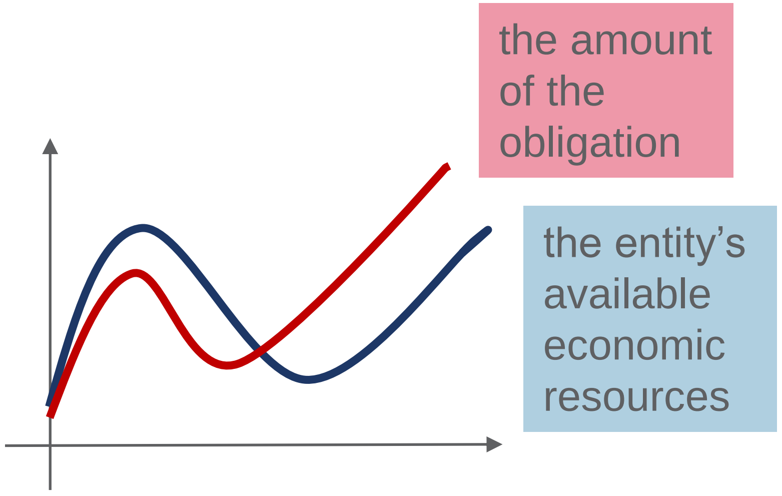
Amount independent of the entity’s available economic resources?

For example,



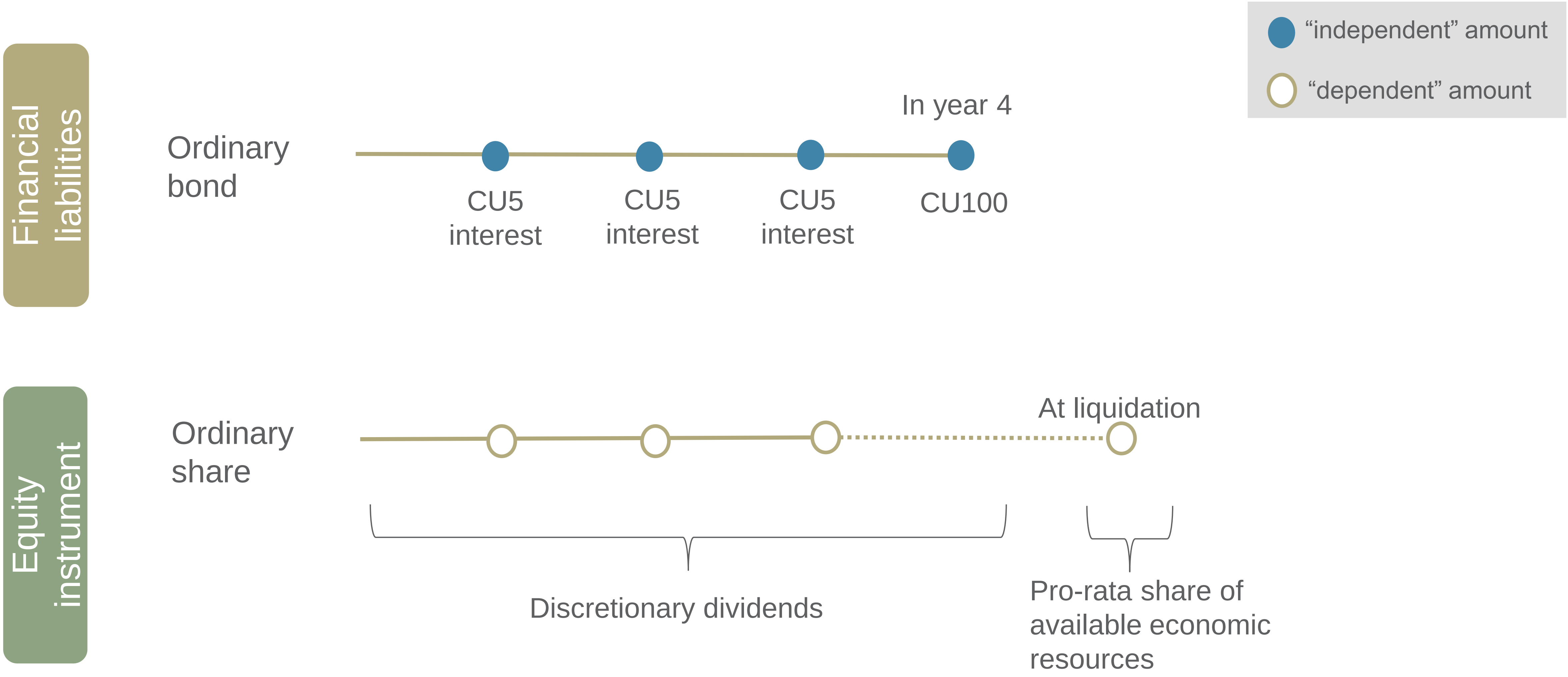
Does not change

OR



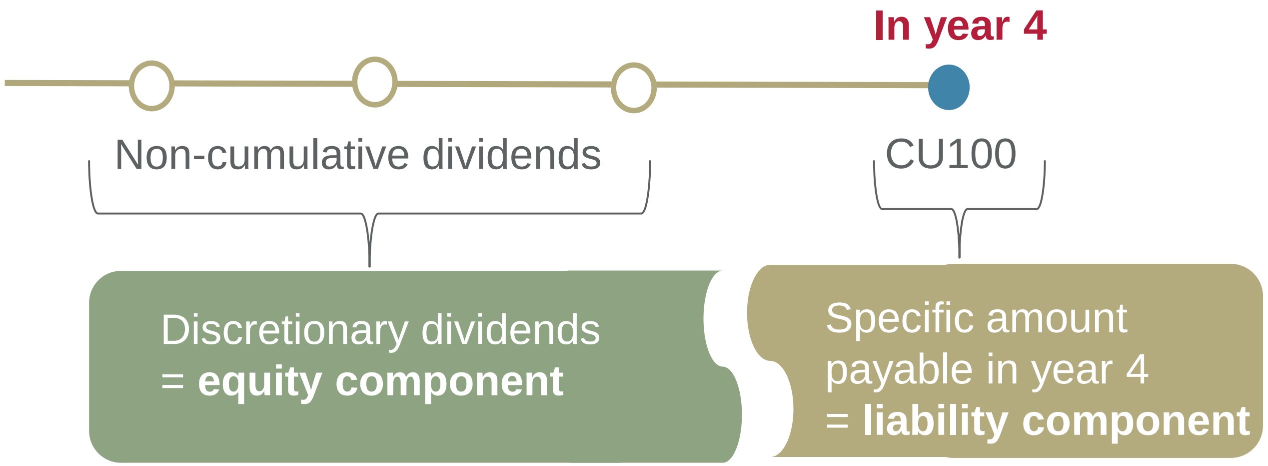
Could exceed

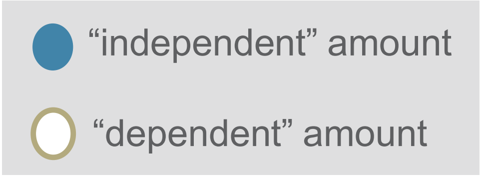
Summary: Non-derivative financial instruments



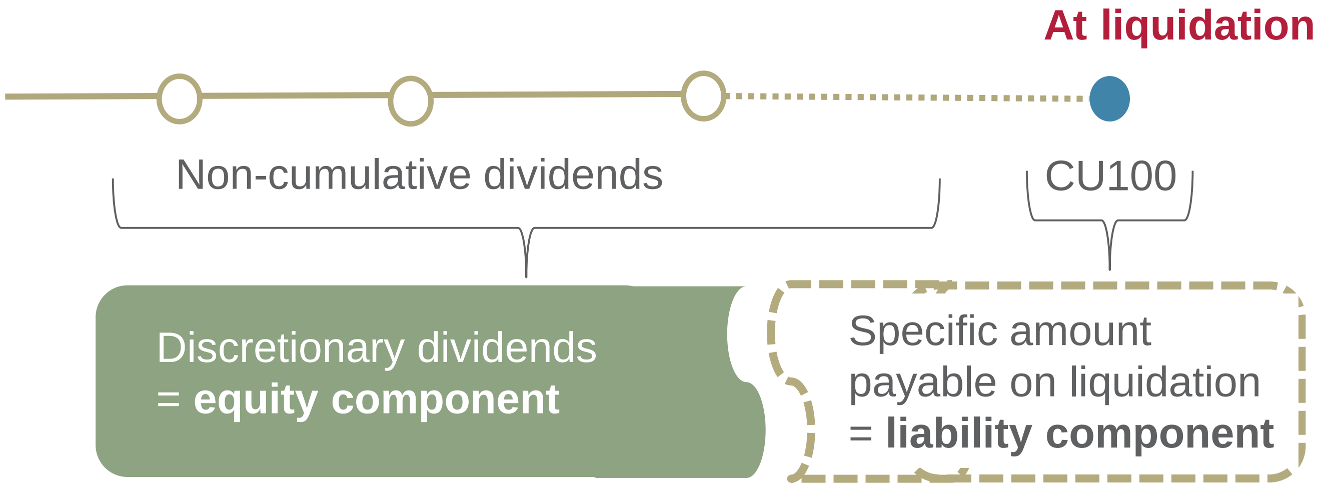
Summary: Non-derivative financial instruments (cont.)

Instrument that pays discretionary dividends and a fixed amount of principal at maturity





Non-cumulative preference share, pays discretionary dividends until liquidation



However PV ~ 0

Summary: Non-derivative financial instruments (cont.)

“independent” amount

Financial liabilities

Cumulative preference share

CU5 dividend

CU5 dividend

CU5 dividend

At liquidation

CU100 **plus any unpaid dividends**

Obligation to pay dividends (specific amounts)

+

Specific amount payable on liquidation

PV ~ 0

Section 4 Classification of derivative financial instruments

What are derivatives on own equity?

- Derivatives settled in an entity's own equity instruments, or derivatives in which the underlying is the entity's own equity instruments.
- Derivatives on own equity:
  - can be gross physically settled, net-cash settled or net-share settled.
  - can be unconditional (eg forwards) or at the option of the holder (eg written options), or the issuer (eg purchased options), or contingent on some other event.

What are derivatives on own equity? (cont.)

- The Discussion Paper examines derivatives on own equity as an exchange comprising “two legs”. For example if physically settled:
  - One leg would be the receipt or delivery of equity instruments.
  - The other leg would be receipt or delivery of cash or another financial asset.
- Applying the Board’s preferred approach, derivatives on own equity would continue to be classified *in their entirety*.

Challenges and response

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

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

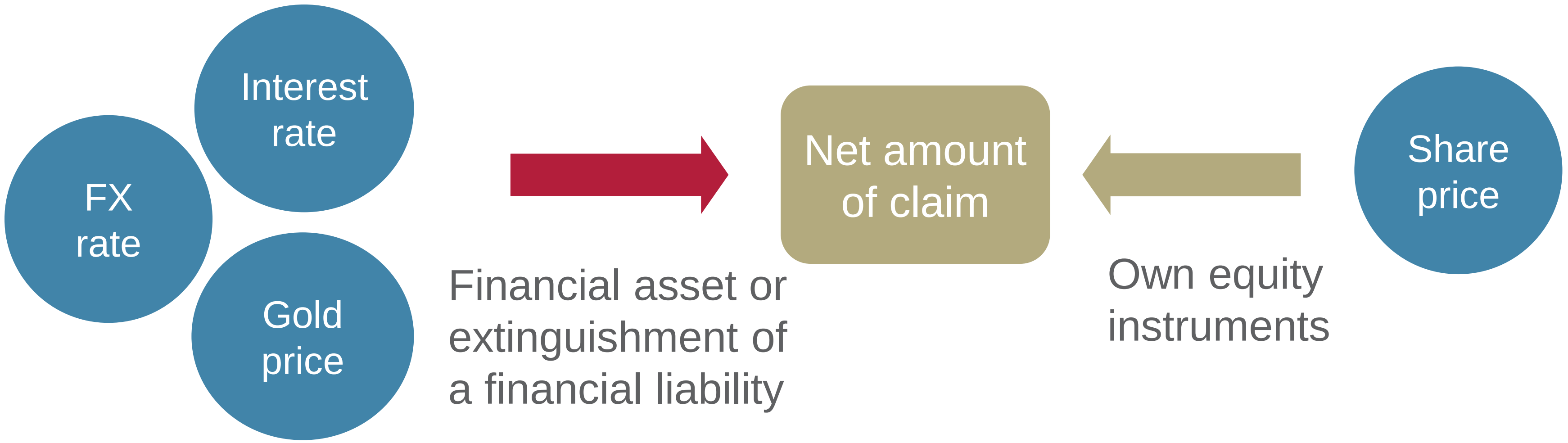
Why is there inconsistency between classification of foreign currency options?

Classification principle that applies consistently to all derivatives

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

Classification principles for derivatives

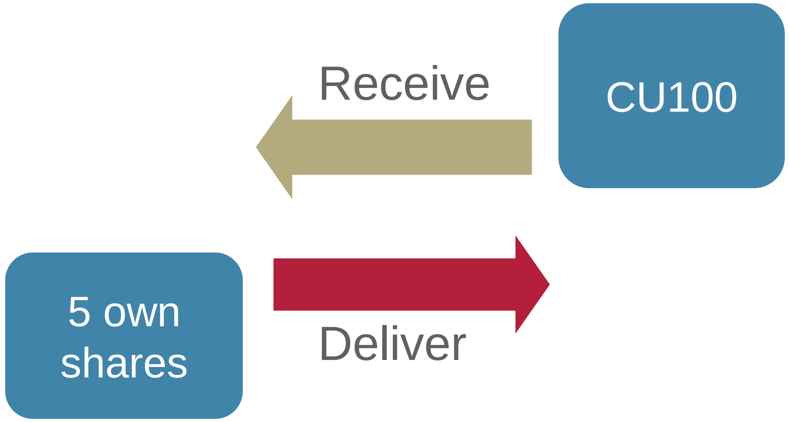
- The Board's preferred approach would classify a derivative on own equity as a financial asset or a financial liability if:
  (a) it is net-cash settled (the 'timing' feature); and/or
  (b) the net amount of the derivative is affected by a variable that is independent of the entity's available economic resources (the 'amount' feature).



Example #1

Written call option

Written call option to sell 5 own shares for CU100 – gross physically settled (ie receive CU100 and deliver 5 own shares)



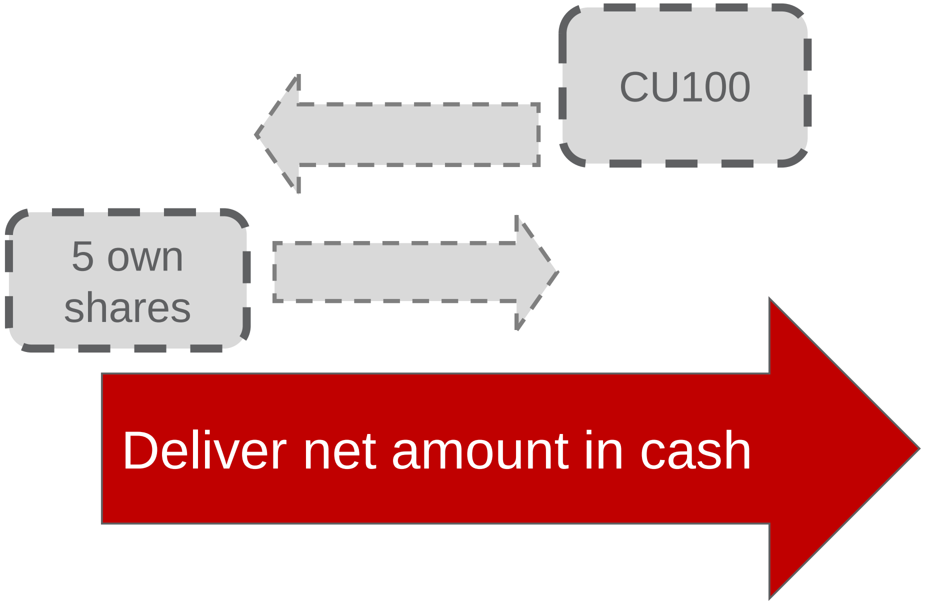
Would it be classified as a derivative liability or equity?		
Timing Feature	Net amount creates an obligation to transfer cash?	✗
Amount Feature	Net amount affected by any variable other than own share price?	✗

Classified as equity

Example #2

Written call option

Written call option to sell 5 own shares for CU100 – net cash settled.



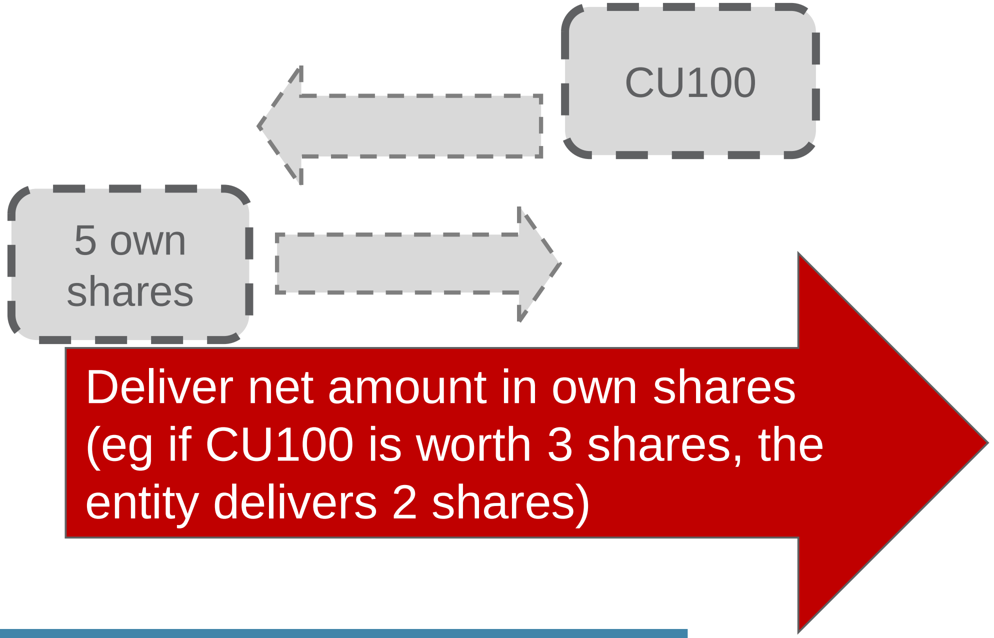
Would it be classified as a derivative liability or equity?	
Timing Feature	Net amount creates an obligation to transfer cash? ✓
Amount Feature	Net amount affected by any variable other than own share price? ✗

Classified as a financial liability

Example #3

Written call option

Written call option to sell 5 own shares for CU100 – net share settled.



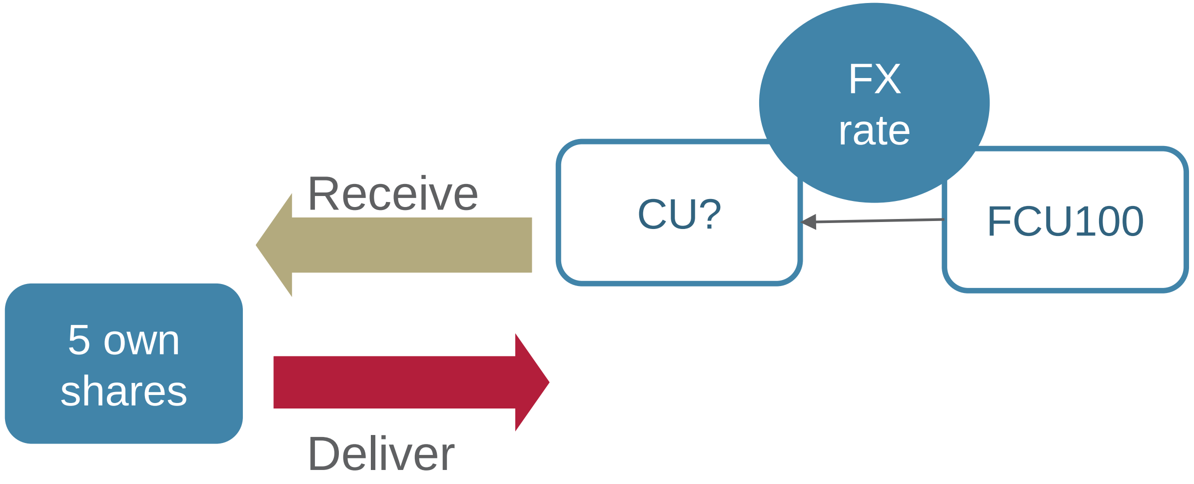
Would it be classified as a derivative liability or equity?		
Timing Feature	Net amount creates an obligation to transfer cash?	✗
Amount Feature	Net amount affected by any variable other than own share price?	✗

Classified as equity

Example #4

Written call option

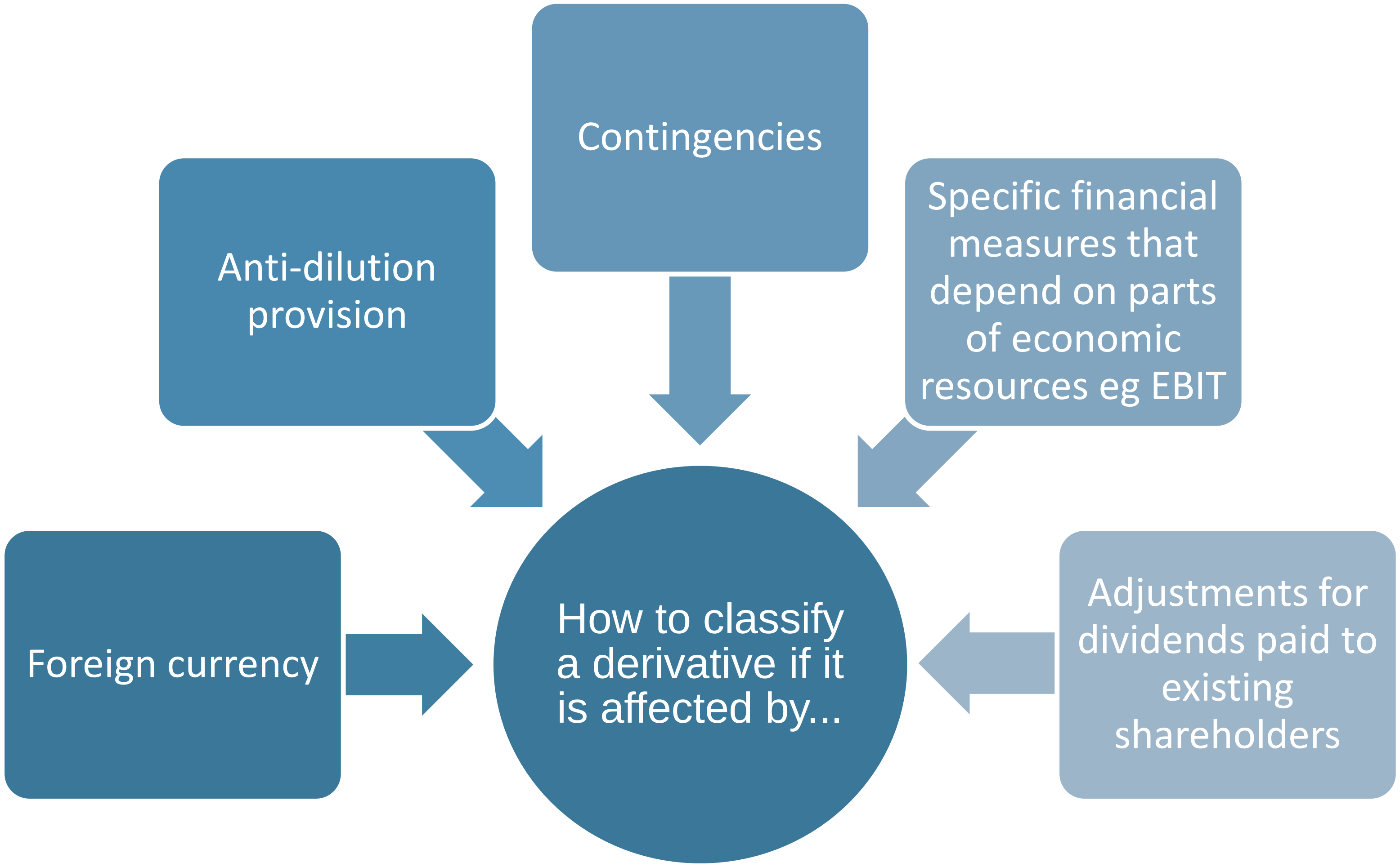
Witten call option to sell 5 shares for 100 foreign currency units (FCU) – gross physically settled.



Would it be classified as a derivative liability or equity?		
Timing Feature	Net amount creates an obligation to transfer cash?	✗
Amount Feature	Net amount affected by any variable other than own share price?	✓

Classified as a financial liability

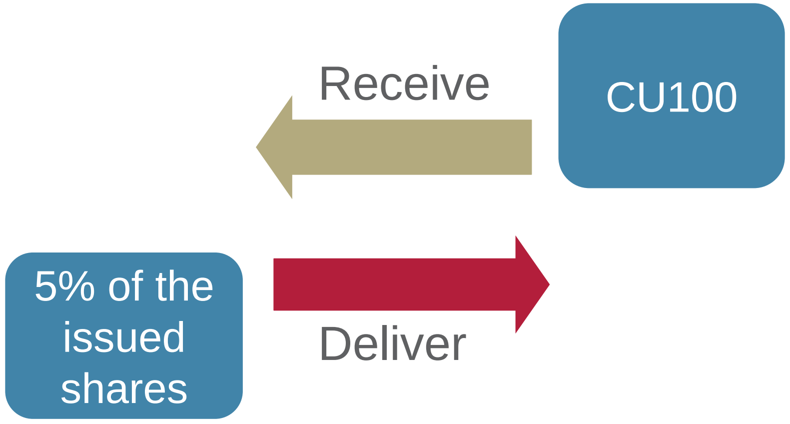
Examples of variables



Example #5

Written call option

A derivative that requires an entity to deliver a variable number of own shares that represent 5% of issued shares for CU100 (in functional currency of the entity)–gross physically settled.



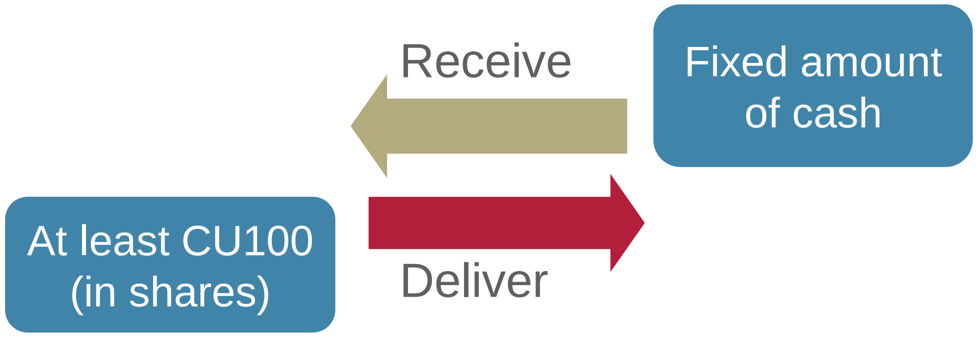
Would it be classified as a derivative asset/liability or equity?	
Timing Feature	Net amount creates an obligation to transfer cash?
Amount Feature	Net amount impacted by any variable other than own share price?

Classified as equity

Example #6

Written call option

A derivative that requires an entity to deliver 100 own shares for a fixed amount of cash subject to an adjustment that will occur in the event of dilution so that the holder receives shares worth at least CU100 in all circumstances – gross physically settled.



Would it be classified as a derivative asset/liability or equity?		
Timing Feature	Net amount creates an obligation to transfer cash?	✗
Amount Feature	Net amount impacted by any variable other than own share price?	✓

Classified as a financial liability

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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 call option on own equity (receive cash and deliver own equity, if the holder exercises)		
Net-cash settlement	Financial liability	Financial liability
Net-share settlement	Financial liability	**Equity**
Gross physical settlement	Equity	Equity

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
Purchased call option on own equity (receive own equity and deliver cash, if the entity exercises)		
Net-cash settlement	Financial asset	Financial asset
Net-share settlement	Financial asset	**Equity**
Gross physical settlement	Equity	Equity
Purchased put option on own equity (receive cash and deliver equity, if the entity exercises)		
Net-cash settlement	Financial asset	Financial asset
Net-share settlement	Financial asset	**Equity**
Gross physical settlement	Equity	Equity

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 sell own equity (receive cash and deliver own equity)		
Net-cash settlement	Financial asset/liability	Financial asset/liability
Net-share settlement	Financial asset/liability	**Equity**
Gross physical settlement	Equity	Equity

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Section 5 Compound instruments and redemption obligation arrangements

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

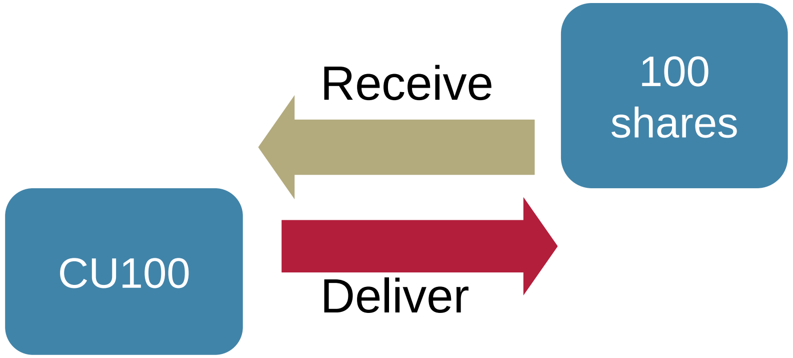
Section 5 compound instruments and redemption obligation arrangements

- 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.

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 the strike price, 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.

Ultimate outcome is either own shares outstanding or payment of cash – **and the entity cannot control the outcome**

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 at fair value at date put options are issued
- 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

Contingent convertibles

Questions applying IAS 32

How to identify liability and equity components?

How to allocate initial carrying amount to components?

Interactions with law and regulation?

The Board's preferred approach

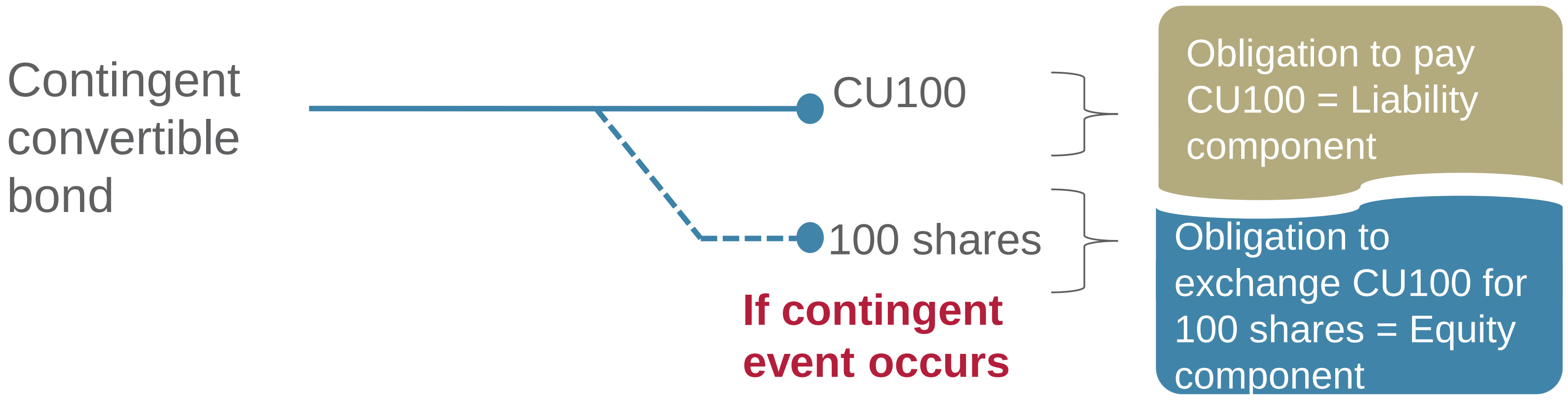
Consistent accounting for unavoidable obligations that meet the definition of a liability

For contingent convertibles, this means:

- Recognise a liability for any unavoidable obligation as if 'standalone'
- Classify remaining rights and obligations using derivative principle

Scope of contractual obligations consistent with IAS 32 and IFRS 9

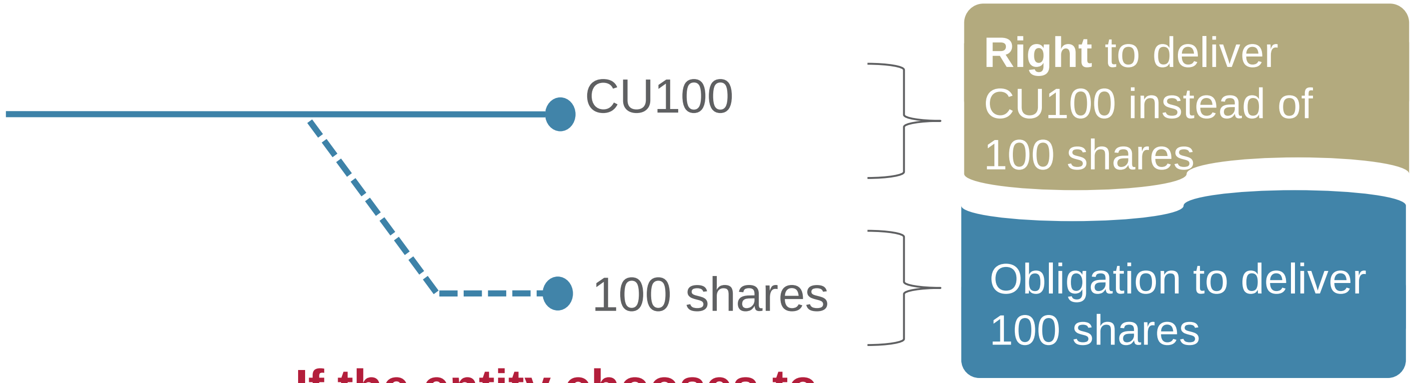
What about contingent convertible bonds?



- 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.

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**

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**

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Section 6A Presentation of equity instruments

Let’s say you are an equity investor

Company A

January 20X0

You purchased ordinary shares of Company A.

You own 100 shares, which represents 0.1% of Company A

December 20X0

Company A makes a profit of CU10,000 for the year.

Company A provides in its financial statements the earnings per share of CU0.10

Your share of profit for the year is CU10 (CU0.10*100).

January 20X1

Company A issues a share warrant to another investor. The warrant allows the investor to buy 20,000 ordinary shares at CU1.70 each.

December 20X1

Company makes a profit of CU15,000 for the year.

How much of the profit belongs to you?

What information would you get from the financial statements of Company A today?

Earnings per share = £0.15

(£15,000/100,000 shares)

Diluted earnings per share = £0.147

(£15,000/ (100,000+20,000-17,895 shares))

Number of ordinary shares to be issued, assuming the warrant is exercised = 20,000 shares

Less Number of ordinary shares that would have been issued at average market price (assume CU1.90)= 17,895 (20,000*CU1.70/CU1.90)

What if the warrant were antidilutive?
For example, the exercise price of the warrant = CU2.00.

Applying IAS 33, the calculation of diluted earnings per share assumes the warrant is not exercised. No further information is provided about the warrant.

Users of financial statements have told us they want more information about…

“risk and rewards of each equity instruments”

“claims that participate in the upside potential of an entity’s economic resources”

“terms and conditions of equity instruments and about equity instruments issued and redeemed during a reporting period”

would like more information about…

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The Board's preferred approach to presentation of 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 three possible methods

No preliminary view formed

Step 4: ordinary shares

Present the remaining income and expenses attributable to ordinary shares

Information provided today

Statement of changes in equity	Share capital and share premium	Other equity instruments	Retained earnings	Other reserves
As at 1 Jan 20X0	XXX	XX	XXX	XX
Profit for the year			XX	
Other Comprehensive income			X	(X)
Total comprehensive income for the year			**XX**	**XX**
Share issuance	XX			
Dividends to shareholders			(XX)	
As at 31 Dec 20X0	**XXX**	**XX**	**XXX**	**XX**

What if the company has sold options to issue more ordinary shares??

Not clear if paid to ordinary shares vs other equity

Balance includes non-derivatives (e.g. preference shares) and derivative equity instruments (e.g. option to issue ordinary shares)

What is the proposal?

Statement of changes in equity	Share capital and share premium	Non-cumulative preference shares	Option to issue ordinary shares	Retained earnings	Other reserves
As at 1 Jan 20X0	XXX	XX	X	XXX	XX
Profit for the year				XX	
Other Comprehensive income				X	(X)
Total comprehensive income for the year	1 XX		X	(XX)	
Share issuance	XX				
Dividends declared on preference shares				2 (X)	
Dividends on ordinary shares				(XX)	
As at 31 Dec 20X0	XXX	XXX	X	XXX	XX

Allocate a share of total comprehensive income to reflect value transfers. But how?
Eg changes in the fair value of the option?

1 For derivative equity instruments, show how total comprehensive income is attributed to derivative equity instruments and ordinary shares.

2 For non-derivative equity instruments, show the amount of dividends paid/declared (the amount required to be adjusted for EPS calculation per IAS 33)

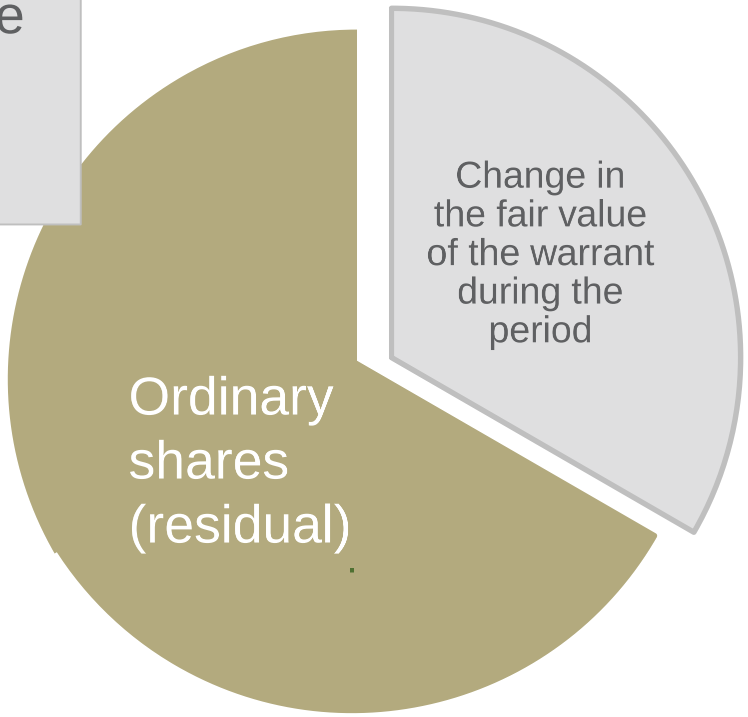
Approaches to attribution for derivatives

Full fair value approach	Average-of-period approach	End-of-period approach
Attribute total comprehensive income to derivative equity instruments equal to change in their fair value.	Use the average-of-period fair value ratio to apportion the entity's total comprehensive income for the period.	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 ratio of fair values.

Or
Disclosure only

Option 1 Full fair value approach

Input:
fair value of the warrant at the reporting date



- Similar information about changes in fair value of all derivatives on own equity regardless of their classification

- Changes in the fair value could exceed total comprehensive income, resulting in a negative amount being attributed to ordinary shares even when the entity made a profit.

Option 2 Average of period approach

Input: average of period fair value of the warrant

Calculate the fair value ratio

Input: average of period fair value of ordinary shares

Apply the average of period fair value ratio to attribute **total comprehensive income**

Total comprehensive income

Ordinary shares

Warrant

- The amount attributed to derivative equity instruments and ordinary shares proportionate to their fair value.
- Similar to IAS 33 diluted EPS approach but uses the fair value instead of strike price as a basis, and takes into account both dilutive and antidilutive effects.

- However, the average-of-period approach might not provide useful information about the end-of-period carrying amounts.

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Option 3 End of period approach

Input: reporting date fair value of the warrant

Calculate the fair value ratio

Input: reporting date fair value of ordinary shares

Net assets (ie equity) of the entity to allocated to each

Net assets (equity)

Ordinary shares

Warrant

Carrying amounts reflect relative fair values

- might better depict the relative carrying amounts of the total of the different components of equity at the end of the period than other approaches.

- However, may not accurately depict distribution of returns during the period because changes in the carrying amounts of derivative equity instruments would include catch-up and other adjustments.

Option 4 Disclosure

Note X Fair value of equity instruments other than ordinary shares

20X1	Carrying amount (CU)	Fair value (CU)
Warrants	9,000	10,000

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Section 6B Presentation of financial liabilities

What is the problem?

The returns on some financial liabilities behave like the returns on equity instruments but they are classified as financial liabilities because they contain an obligation to pay cash prior to liquidation. What is the best way to show the effects of such financial instruments on the issuer's financial position and financial performance?

Instrument X: Company A issues a financial instrument that requires it to make a cash payment in five year's time for the fair value of 100 own shares on the settlement date

If Company A performs poorly, its share price would decrease. In turn, the amount of cash payable on Instrument X decreases.

As the amount of cash payable on Instrument X decreases, Company A records a gain on that instrument. Today, this gain is reported in profit or loss.

The scope of separate presentation

- Financial liabilities that contain no obligation for an amount independent of the entity's available economic resources
- Derivatives classified as financial assets/liabilities that have a net amount unaffected by any "independent variables"
- Particular foreign currency derivative assets/liabilities that are "partly independent"

Separate presentation in statement of financial performance

Contains an obligation for an amount independent of the entity's available economic resources?*

YES

Income statement (Profit or Loss)	
Income and expenses from financial liabilities that have the amount independent of the entity's available economic resources	X/(X)
Profit for the period	XXX

NO

Statement of other comprehensive income	
Income and expenses from financial liabilities and derivative assets/liabilities that the amount NOT independent of the entity's available economic resources	X/(X)
Other comprehensive income	XXX

No recycling

*For derivatives, is the net amount of the derivative affected by any independent variable? For partly independent own equity derivatives, consider the specific criteria (see slide 9).

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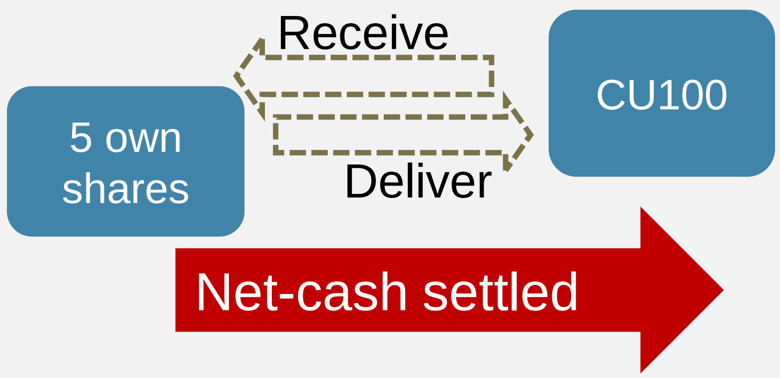
Derivatives with the net amount unaffected by any independent variables

Consider an example:
Written call option on own shares

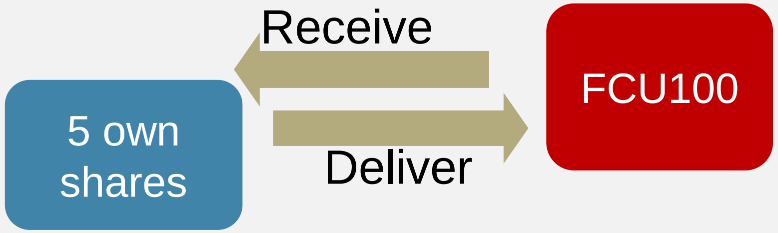


- Classified as a derivative liability because of an obligation to deliver cash
- But the net amount of the written call option is unaffected by any independent variable, ie its income and expenses are driven by changes in the entity's available economic resources.

Present total income and expenses in respect of this derivative in other comprehensive income

Partly independent derivatives

Consider an example:
Written call option on own shares (gross physically settled)



- Classified as a derivative liability because the net amount of the call option is affected by an independent variable (FX rate)
- But its income and expenses would include the effect of changes in the entity's available economic resources

Assess whether the derivative meets specified criteria (see slide 9)

Present total income and expenses in respect of this derivative in other comprehensive income

The criteria-based approach

Criteria-based approach−apply separate presentation to income and expenses in respect of a financial instrument if the following applies:	
Non-derivative financial liabilities	**No** contractual obligation for an amount independent of the entity's available economic resources
Own equity derivatives	**No** variable independent of the entity's available economic resources affects the net amount
Foreign currency derivatives on own equity	Meets all of the following criteria: • the only independent variable affecting the net amount is a currency other than the entity's functional currency. • the foreign currency (FX) exposure is not leveraged. • the FX exposure does not contain an option feature. • The FX denomination is imposed by an external factor.

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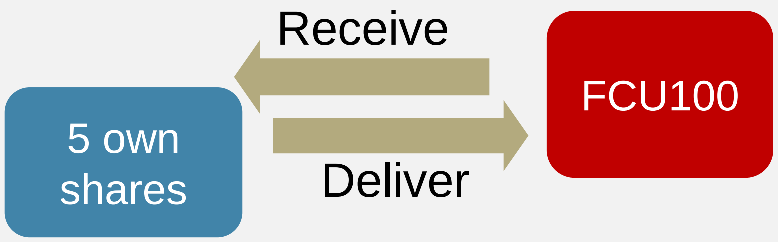
Criteria-based approach vs Disaggregation approach

Written call option on own shares (gross physically settled)



Assume that:

- Total income on the call option for the period represents a fair value gain of CU10
- Out of CU10, CU3 is attributed to the effect of the independent variable (foreign currency variable)
- the call option meets all the specific criteria (see slide 9)

The Board's preferred option

Criteria-based approach

Statement of other comprehensive income (OCI)	
Fair value gain	10
Other comprehensive income	XXX

Disaggregation approach

Income statement	
Fair value gain - "independent" portion	3
Profit	XXX

Statement of OCI	
Fair value gain - "dependent" portion	7
Other comprehensive income	XXX

What if embedded derivatives are not separated?

Foreign currency convertible bond

Fair value option

Host financial liability

Embedded conversion option

No preliminary view reached

A

Separate presentation does not apply to the foreign currency convertible bond as the bond as a whole includes an obligation for an amount independent of the entity's available economic resources

Apply separate presentation only to embedded derivatives that are separated and hybrid instrument that contain no obligation for an amount independent of the entity's available economic resources

B

Separate presentation applies to the embedded written call option subject to specific criteria (see slide 9) *even though* the entity would have elected to measure the foreign currency convertible bond as a whole at fair value through profit or loss

Apply separate presentation to all embedded derivatives regardless of whether the FVO option is applied or not

Separate presentation in statement of financial position

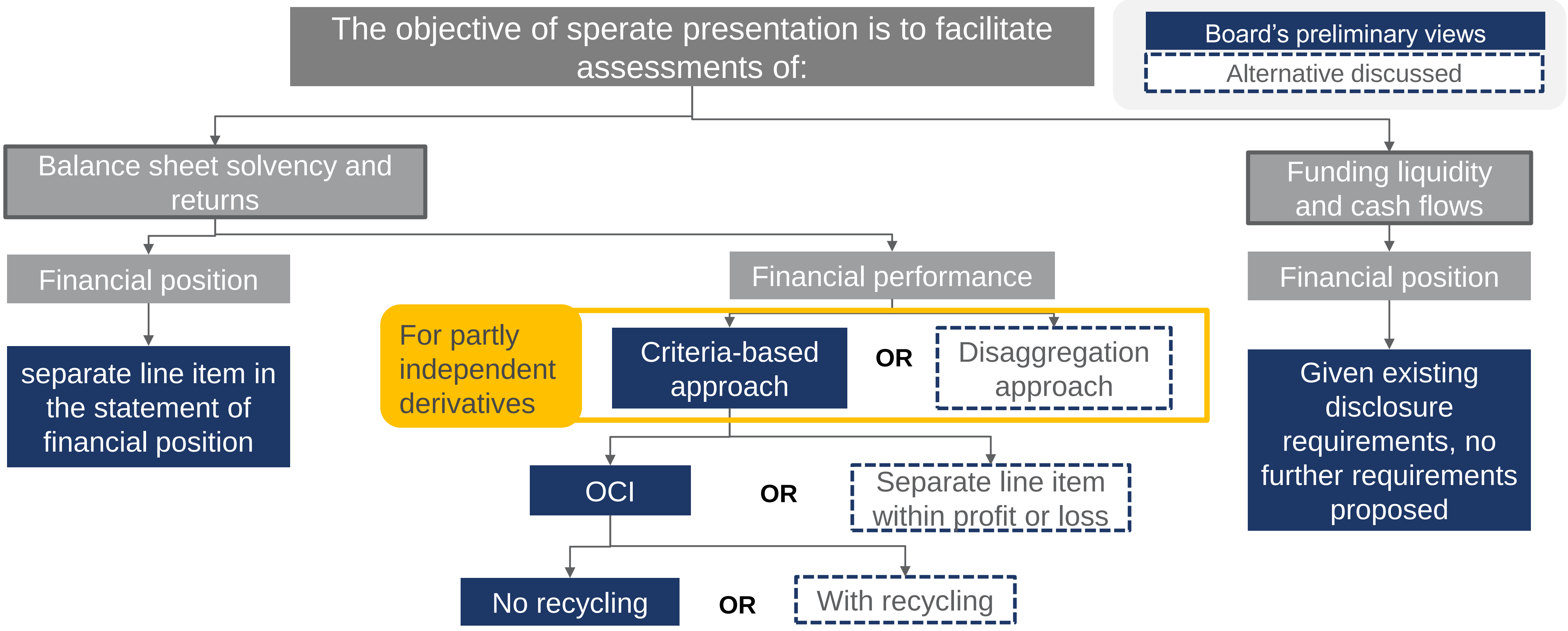
Use separate line items in the statement of financial position, for example

Statement of financial position	
Derivative financial liabilities	
independent of the entity's available economic resources	XXX
not independent of the entity's available economic resources	XXX
Non-derivative financial liabilities	
independent of the entity's available economic resources	XXX
not independent of the entity's available economic resources	XXX

Enable users of financial statements distinguish financial instruments with different return characteristics

Enable users of financial statements distinguish financial instruments with different return characteristics

Summary of preliminary views



Note: For hybrid instruments that are measured as a whole under the Fair Value Option, no preliminary view was reached as to whether the separate presentation requirements should be applied to all embedded derivatives or separated embedded derivatives only (see slide 11).

Section 7 Disclosure

Disclosures

- The Discussion Paper explores possible requirements to disclose:
  - the priority of claims on liquidation
  - the potential dilution of ordinary shares
  - terms and conditions that are relevant to understanding of the timing or the amount feature

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

Disclosure - Priority of claims on liquidation

- Currently, IFRS disclosure requirements do not specify any specific disclosures resembling the example below.
- In the DP, the Board proposes that disclosures similar to the table below be presented either on the face of the financial statements, or in the notes.

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**

Applies to all financial liabilities as well as equity instruments

Disclosure - Potential dilution of ordinary shares

- Reconciliation of changes during the period in the number of:

a) ordinary shares outstanding and

b) the maximum number of additional potential ordinary shares that could be issued

	Ordinary shares outstanding	Maximum number of potential ordinary shares
1 January 20X1	5,000,000	900,000
1 January 20X1 Issue of warrants	-	600,000
1 March 20X1 Issue of ordinary shares for cash	200,000	-
1 June 20X1 Conversion of bonds	20,000	(20,000)
1 September 20X1 Exercise of warrants	400,000	(400,000)
31 December 20X1	5,620,000	1,080,000

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Terms and conditions affecting the timing and the amount of cash flows

- For example,
  - terms and conditions that are relevant to determining the settlement amount such as those that affects the financial instrument's principal amount, interest rate, indices and whether and how the settlement amount depends on the entity's available economic resources (such as indexation to share price) and the effect of any options and contingencies; and
  - the timing of settlement including the effect of any options and contingencies.
- To be provided in a single place in the notes to the financial statements.
- Challenges exist, for example, the level of aggregation.

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Section 8 Contractual terms

Economic compulsion and indirect obligations

- Some claims against an entity grant *the entity* the right to choose between alternative settlement outcomes, instead of granting that right to the counterparty or holder, eg reverse convertible bond.
- Preliminary view is that, consistent with IAS 32 today, economic incentives of the entity should not be considered when classifying a claim as either a liability or equity. Classification would be based on rights and obligations established by a contract, including obligations that are established indirectly through the terms of the contract.

Economic compulsion and indirect obligations (cont.)

- Applying the proposed approach, financial instruments such as the callable preferred shares with resets, and cumulative preference shares, would be classified as liabilities because of the “independent” amount feature.
  - There is no need to consider economic incentives and compulsion in arriving at the classification conclusion for these types of claims.

Interaction between contracts and law

- There are questions about whether classification should consider the effect of law on the rights and obligations of an existing contract (other than just their enforceability). That is, whether the contract :
  - is limited to the contractual terms, or
  - includes the effect of law.
- Examples include some types of contingent convertible bonds and mandatory tender offers.
- Preliminary view is that, consistent with IAS 32 and IFRS 9 today, classify claims based on the contractual terms of a financial instrument.

Questions?

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