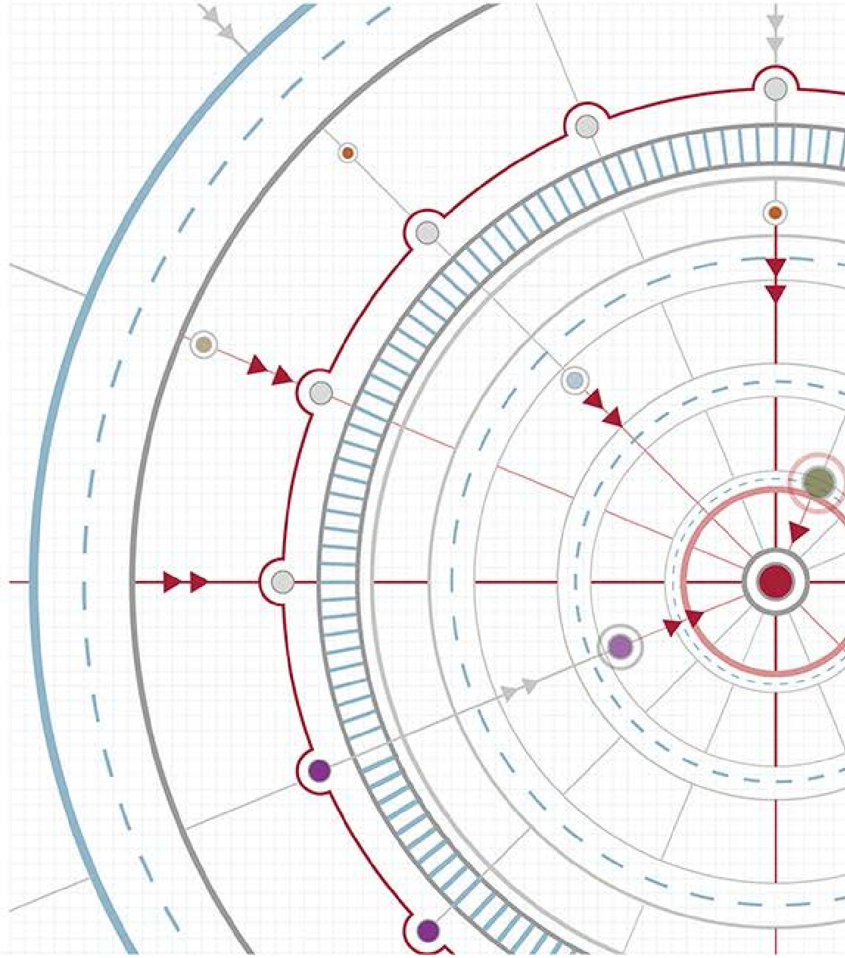

Financial Instruments with Characteristics of Equity

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Agenda

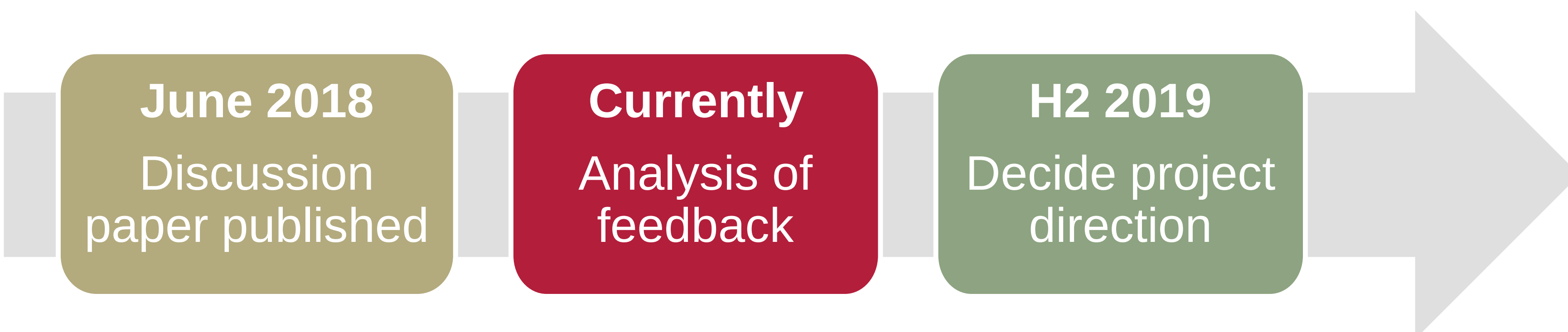
- Project overview
- Proposals in the Discussion Paper
- Feedback received on the Discussion Paper proposals
- Questions for the Boards

Objective of the session

- To provide an overview of the proposals in Discussion Paper *Financial Instruments with Characteristics of Equity* published in June 2018 (DP) and the feedback received from stakeholders
- To obtain feedback from FASB Board members if they have any observations that might be useful for the project

Project overview

- Project objective
  - 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*
- Project timeline



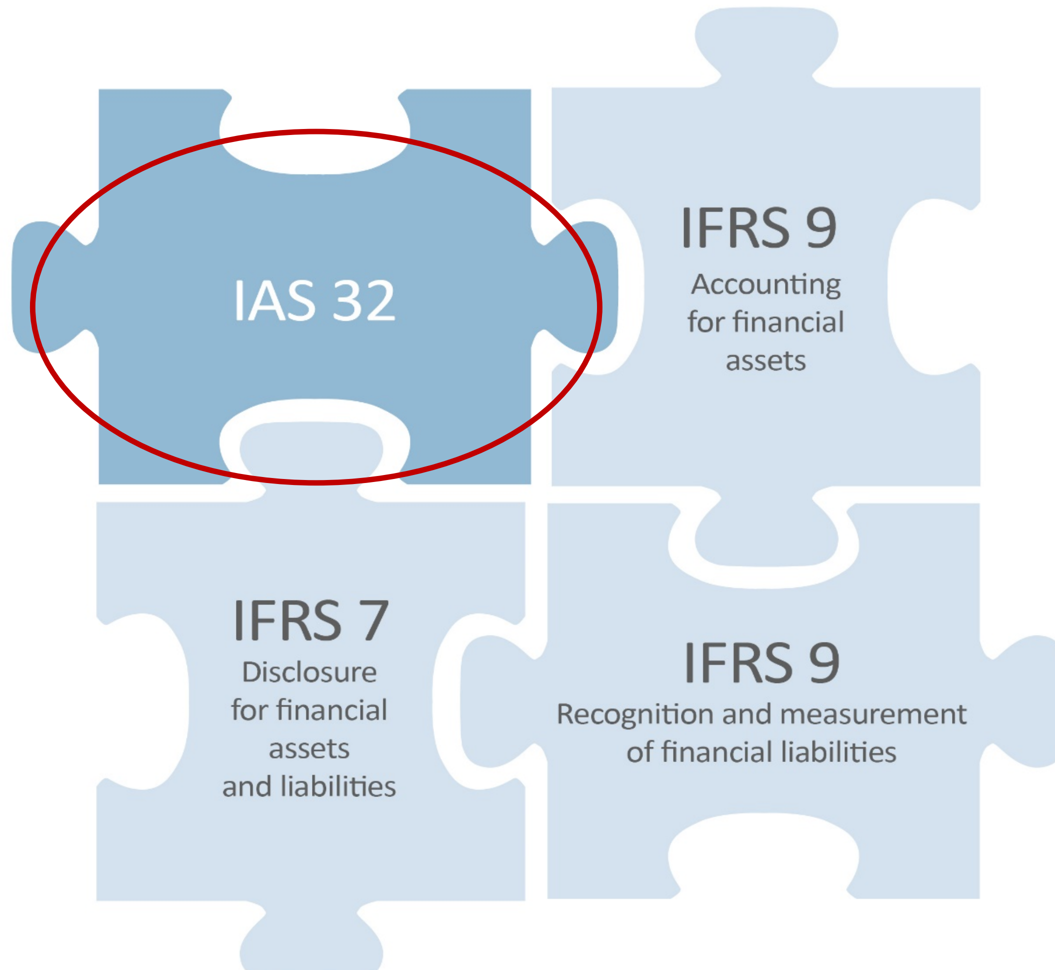
Project overview (2)

In scope

- Classification of financial instruments as financial liabilities or equity instruments
  - issuer perspective
  - including derivatives on own equity

Not in scope

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



IFRS

Proposals in the DP

Key components of the DP

Classification

- Still a binary distinction
- Clear principles
- Addresses accounting diversity in practice
- Limited changes to classification outcomes

Presentation

- Separate presentation for liabilities with value based on ‘residual’
- Attribution of performance to classes of equity

Disclosure

- Consider investor information needs re: dilution, liquidity, solvency

DP proposals—classification principle

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

Does the issuer have an unavoidable obligation to transfer cash or another financial asset before liquidation?

Timing feature

Does the issuer have an unavoidable obligation to transfer an amount independent of the issuer's available economic resources?

Amount feature

Otherwise, it is an equity instrument

DP proposals— classification outcomes and presentation proposals

Amount feature / Timing feature	Obligation for **an amount independent** of the entity's available economic resources	No obligation for an amount independent of the entity's available economic resources
Obligation to transfer of cash or another financial asset **at a specified time other than at liquidation**	**Liability**	**Liability***
Obligation to transfer economic resources **only at liquidation**	**Liability**	**Equity****

Presentation proposals

*Present income and expenses in OCI without recycling

**Attribute total comprehensive income to subclasses of equity

DP proposals—disclosure

Priority on liquidation	• Priority of all financial liabilities and equity instruments on liquidation of the entity
Potential dilution of ordinary shares	• Applies to financial instruments that may be settled in own shares • Shows maximum number of ordinary shares an entity may need to deliver to settle such financial instruments outstanding at the reporting date, eg assuming all convertible bonds will be converted into shares • A reconciliation of movement during the period
Terms and conditions	• Applies to financial liabilities and equity instruments • Terms and conditions that are relevant to determining the timing and amount of cash flows of a financial instrument • For example, if the issuer has an option to redeem an instrument, the timing and the amount of the redemption and if it depends on a trigger event, the description of that event

IFRS

Feedback received on the Discussion Paper proposals

Overview – feedback on the key components of the Discussion Paper proposals

Classification

- Timing feature
- Amount Feature
- Contractual terms

Presentation

- Separate presentation of financial liabilities
- Attribution within equity

Disclosure

- Priority on liquidation
- Potential dilution of ordinary shares
- Contractual terms and conditions

Key

- Green: Broadly agree with some limited qualifications/questions
- Amber: Partially agree with a number of concerns
- Red: Broadly disagree and a significant level of concerns raised

Is standard-setting required to address the known challenges?

Targeted improvements to IAS 32, eg derivatives on own equity, written put options on non-controlling interest

General support for standard-setting to address known practice issues but mixed views on how

A more fundamental review to address broader conceptual challenges either as a follow up or instead of a project focusing on targeted improvements

Request for more application guidance

Disclosure-focused project

Derivatives on own equity

Today (IAS 32)	Discussion Paper	Feedback received
A derivative is classified as a financial asset or a financial liability **unless** the derivative meets the so-called 'fixed-for-fixed' condition (gross-physically settled) Practice challenges exist in relation to interpretation of the fixed for fixed condition	A derivative would be classified as a financial asset or a financial liability if: • it is net-cash settled; and/or • the net amount of the derivative is affected by a variable that is independent of the entity's available economic resources The DP discuses examples of variables, eg anti-dilution provisions and foreign currency	• Guidance in this area is welcomed • Request for further clarity and more examples • Determining whether a variable is independent of an entity's economic resources requires significant judgements and may lead to new interpretation issues

Written put options on NCI

Today (IAS 32)	Discussion Paper	Feedback received
If a contract that contains an obligation for an entity to repurchase its own equity instruments for cash or another financial asset, recognise a financial liability for the present value of the redemption amount and **'reclassify'** from equity Accounting diversity exists especially the reclassification of equity	Clarifies the order of analysis and proposes: • recognition of a financial liability and **derecognition of equity instruments** rather than 'reclassification' • in the case of written put option, recognition of '**an implicit call option**' that represents the holder's right to keep the shares	• Strong support for the Board addressing the issue • Concerns expressed about: - the consequences of derecognising equity instruments, eg the effects on profit or loss allocation and EPS calculation - Recognition of gross financial liabilities

Disclosures

Today	Discussion Paper	Feedback received
• Limited disclosure requirements for equity instruments • No specific disclosure requirements on priority of financial instruments on liquidation • Disclosure required for earnings per share but it does not capture all potential dilution	Disclosure proposed for: • Priority on liquidation • Potential dilution of ordinary shares • Contractual terms and conditions that affects the timing and amount of cash flows (eg contingent conversion options, issuer call options)	• Broad support, particularly strong support from investors • Some concerns about providing priority on liquidation • Some warned against ‘disclosure overload’ of terms and conditions • Request for improvement to the EPS disclosure requirements

Amount feature—obligations that arise only on liquidation

Today (IAS 32)	Discussion Paper	Feedback received
A financial instrument is generally **not a financial liability** if it requires the entity to deliver cash or another financial asset only on the liquidation of the issuer	A financial instrument **is a financial liability** if the amount of the obligation is independent of the entity's available economic resources regardless of when the obligation requires settlement, ie liability classification even if settlement is only required at liquidation of the entity	Concerns expressed about: • Inconsistency with the going concern assumption • Changes in classification affecting many financial instruments, eg hybrid bonds, regulatory capital instruments • Measurement challenges

Feedback on the presentation proposals

	Discussion Paper	Feedback received
Separate presentation of financial liabilities	• Present in OCI without recycling income and expenses on financial liabilities with ‘equity-like’ returns • Present in a separate line item on balance sheet	• Useful to distinguish • Mixed views on OCI vs profit or loss • Mixed views on recycling vs non-recycling
Attribution of total comprehensive income to equity instruments	• Non-derivatives: attribution based on dividends paid or declared • Derivatives: multiple methods considered using fair value as the basis	• Costs > Benefits • Complex to understand—attribution methods for derivatives in particular • Some support for attribution for non-derivatives

Feedback on contractual terms

Today (IAS 32) & Discussion Paper	Feedback received
Classification of financial instruments should be based on the contractual terms, ie classification should not take into account: • economic incentives of the issuer • the effects of law and regulations	• General agreement • Practice issues highlighted • Request for: - application guidance - addressing internal inconsistency in IAS 32 • Consider a longer-term project to address the issue more comprehensively

Questions for the Boards

- Do Board members have any questions about the proposals in the DP or the feedback received?
- Do FASB Board members have any observations about the project that they would like to share based on their own experience?

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