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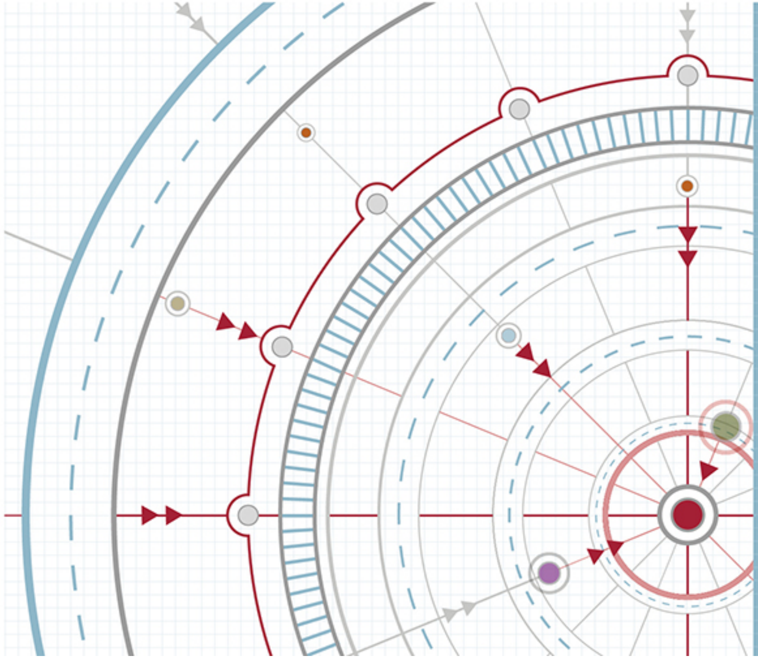

CMAC meeting, 1 November 2018

Agenda paper 3

Discussion Paper

Financial Instruments with Characteristics of Equity

The views expressed in this presentation are those of the presenter,
not necessarily those of the International Accounting Standards Board (the Board) or
IFRS Foundation.

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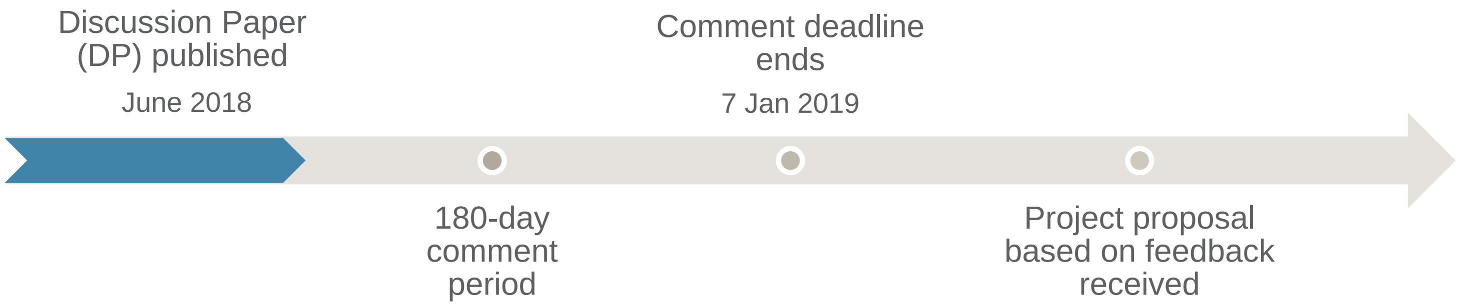
About the project

- 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/

Agenda for this session

60 minutes

- Education session agenda
  - Disclosure topics (slides #5−12, 20 minutes)
  - Presentation topics (slides #16−21 and #24−27, 30 minutes)
  - Classification topics (slides #30−33, 10 minutes)

60 minutes

- Discussion session agenda
  - Disclosure topics (slides #13−14, 20 minutes)
  - Presentation topics (slides #22 and #28, 40 minutes)

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Disclosure

What have we heard?

- risks and rewards of each equity instrument
- 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

Investors would like more information about…

Example of information disclosed

Note X Equity instruments

At 31 December 2017, perpetual subordinated bonds are carried in equity at the amount of CUXXX million.

Interest paid by the Group to the bearers of perpetual subordinated bonds issued in January 2013 and January 2014 totalled CUXX million in the year 2017 and CUXX million in the year 2016. The resulting cash payout is reflected in a corresponding reduction in Group equity.

In January 2018, the Group paid interest of around CUXX million.

[A list of issued perpetual subordinated bonds is disclosed in a table. The disclosure includes issue date, issue amount, currency, repayment option and rate.]

Other equity instruments
Other equity instruments are financial instruments issued by the Group that qualify as equity instruments under IAS 32.

In December 2017, the Group issued convertible bonds. At 31 December 2017, the total amount of the instrument recorded in equity is CUXXX million.

What information do financial statements provide today?

Information set provided today for equity instruments

- Earnings per share (EPS)
- Diluted EPS
- Non-controlling interest (NCI)
- Attribution of profit or loss and comprehensive income to NCI and owners** of the parent
- Dividends paid/declared to owners**

**Owners are defined as holders of instruments classified as equity.

Proposed additional information sets (see slides 8-12, 16-21)

a. Maximum dilution of ordinary shares

b. Priority of claims on liquidation^

c. Terms and conditions that affect the timing and the amount of cash flows^

- Attribution of total comprehensive income to classes of equity

^applies to financial liabilities as well as equity instruments

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a Maximum dilution of ordinary shares

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

a) ordinary shares outstanding and

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

- To be provided in the notes

	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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Maximum dilution of ordinary shares (cont.)

- The objective would be for an entity to provide information to help users of financial statements assess the potential dilution of ordinary shares arising from financial instruments that could be settled by issuing ordinary shares.
- In addition to information about potential dilution, users of financial statements also requested information about the effect of new issues of ordinary shares on the voting rights of existing shareholders. Such information about voting rights could be provided along with information about dilution.

b Priority of claims on liquidation

- Currently, IFRS disclosure requirements do not require 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

No preliminary view on whether the amounts disclosed should be the carrying amounts in the financial statements or the fair value

b Priority of claims on liquidation (cont.)

- The Board identified a number of challenges in determining the priority of financial instruments, for example:
  - the priority of a particular financial instrument may be determined by a combination of its own terms and conditions and the terms and conditions of other financial instruments;
  - the priority might be affected by the group structure of the entity, for example, when a claim is against a particular subsidiary;
  - the priority of a financial instrument might be contingent on uncertain future events;
  - limiting this disclosure to financial instruments and not applying the same to non-financial liabilities beyond the scope of IAS 32 might reduce the usefulness of the disclosure.

c Terms and conditions

- For example,
  - terms and conditions that are relevant to determining the settlement amount such as those that affect:
    - the 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 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, eg how granular can/should the information be.

Question for CMAC members

General- disclosures

1) Do you think the proposals in the DP would result in useful information for you? If you were to rank them in the order of priority/usefulness, how would you rank them?
    a) Maximum dilution of ordinary shares
    b) Priority of claims on liquidation
    c) Terms and conditions that affect the timing and the amount of cash flows

Question for CMAC members

Priority of claims on liquidation

2) The Board identified a number of challenges in determining the priority of financial instruments as summarised on slide 11.

   Do you think the priority information would be useful even if such information is prepared with some limitations? For example, those limitations could include simplifying assumptions or requiring the provision of this information only for a particular set of financial instruments (such as limiting it to financial liabilities and equity instruments of, or against, the parent entity).

3) Do you have any suggestions as to how to improve the Board's proposals that will overcome the challenges identified?

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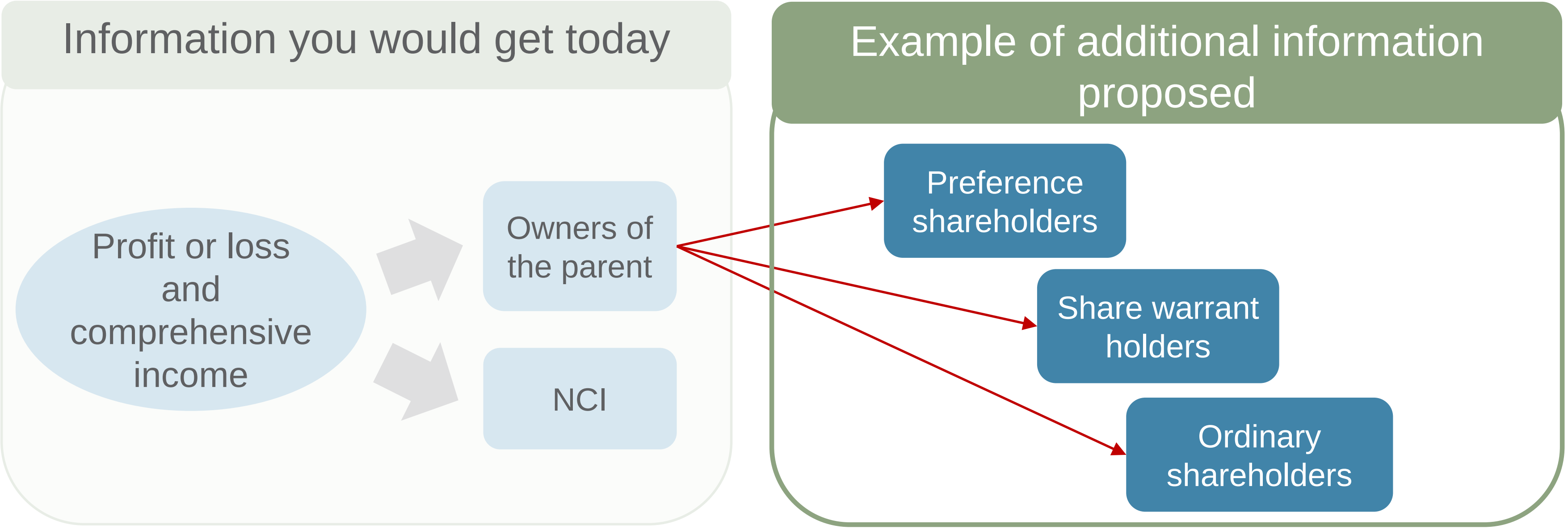
Presentation of equity instruments

What is the proposal?



Investors

More information about equity instruments is needed

Increase the information about how value is shared among those equity instruments

Attribution of total comprehensive income

Step 1: Start with profit or loss and OCI

Step 2: Non-derivative equity instruments

Present separately **the amount of dividends** paid/declared on ordinary shares and other equity instruments such as preference shares

Step 3: Derivative equity instruments

Show **value transfers** between potential ordinary shareholders (ie own equity derivative holders) and ordinary shareholders, eg allocate income equal to changes in fair value of the derivatives. See slide 20 for further information about potential methods

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	Total shareholders' equity
As at 1 Jan 2017	100	50	150	120	**420**
Profit for the year			40		**40**
Other Comprehensive income			8	-6	**2**
Total comprehensive income			**48**	**-6**	**42**
Share issuance	30				**30**
Dividends to shareholders			-12		**-12**
As at 31 Dec 2017	**130**	**50**	**186**	**114**	**480**

Not clear how much belongs to ordinary shares vs other equity, eg 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)

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Illustration of the proposals

Statement of changes in equity	Attributable to shareholders other than share warrants				Option to issue ordinary shares	Total shareholders' equity
	Share capital and share premium	Non-cumulative preference shares	Retained earnings	Other reserves		
As at 1 Jan 2017	**100**	**40**	**140**	**115**	**25**	**420**
Profit for the year			20		20	40
Other Comprehensive income			6	(5)	1	2
Total comprehensive income						**42**
Share issuance	30					30
Dividends declared on preference shares			(2)			-2
Dividends on ordinary shares			(10)			-10
As at 31 Dec 2017	**130**	**40**	**154**	**110**	**46**	**480**

1 For derivative equity instruments, show how total comprehensive income is attributed to derivative equity instruments to reflect value transfers. But how? For example, changes in the fair value of the option?

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

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

Points to consider

How would the attribution be best presented/disclosed?

? to consider

On the face of financial statements vs disclosure of fair value information in the notes

Fair value of an own equity derivative (eg share warrants) may need to include management's assumptions – may be a Level 3 fair value.

? to consider

Would you still find such fair value information useful?

Diluted EPS calculation takes into account only those derivatives that are dilutive at the reporting date, eg currently in the money for the option holder. The proposals would capture all equity derivative instruments.

? to consider

Would you prefer to have enhanced disclosure of the workings of diluted EPS?

Question for CMAC members

Attribution of total comprehensive income

4) Do you think attributing total comprehensive income would provide useful information?

5) If so, which method of attributing total comprehensive income do you think will provide the most useful information?
   a) full fair value approach: changes in the fair value of derivative equity instruments
   b) average of period approach: use the average-of-period fair value ratio to apportion the entity's total comprehensive income for the period.
   c) end-of-period approach: reallocate the end-of-period carrying amount of equity (ie net assets) so as to reflect the end-of-period fair value ratio
   d) disclosure of the fair value of derivative equity instruments at the reporting date (in the notes to the financial statements)

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Presentation of financial liabilities

Financial liabilities with equity-like return

- The returns on some financial liabilities behave like the returns on equity instruments. They are classified as financial liabilities because they include an obligation to pay cash prior to liquidation. However, their value is linked to the “residual value” of the issuer.
- For example, shares redeemable for a cash amount equal to the fair value of ordinary shares.
- Today, gains or losses on these financial liabilities are reported in profit or loss.

Example

Instrument X

- Company A issues a debt instrument with a 5 year term.
- The redemption amount due at maturity will equal the value of 10 ordinary shares.
- Assume no coupon for simplicity.

If Company A performs poorly, its share price would decrease.

Let's say share price has fallen from CU10 to CU8. The amount of cash payable on Instrument X decreases from CU100 to CU80.

As the amount of cash payable on Instrument X decreases, Company A records a gain of CU20 on that instrument.

If Company A performs well, Company A will record a loss.

Today, such gains or losses are reported in profit or loss.

What is the proposal?

Reporting today

Income statement	
Revenue	XXX
Cost of sales	(XXX)
Gross profit	**XXX**
Other operating income	XX
Administrative costs	XX
R&D costs	XX
Operating profit	**XX**
Financing costs	X
Profit before tax	**XX**
Taxation	X
Profit after tax	**XX**

Includes changes in fair value of financial liabilities that have equity-like returns.

Reporting proposed in the DP

Income statement	
…	
…	
Financing costs	X
Profit after tax	XX
Other comprehensive income:	
Fair value gain/losses on financial liabilities linked to equity	20

Shown in the statement of other comprehensive income

Balance sheet:
Still measured at fair value

What is the proposal? (cont.)

- The Board is proposing to require an entity to separately present income and expenses from financial liabilities with returns that behave like the returns on an equity instrument.
- The Board is **seeking feedback on whether to present such income and expenses in:**
  - **OCI** (proposed); or
  - **P&L:** using a separate line item in profit or loss.
- **OCI approach would not include “recycling”:** If other comprehensive income (OCI) is used, the Board’s proposals are that gains or losses on these types of liabilities would not affect profit or loss even if such gains or losses are realised (ie when the liabilities are settled).

Question for CMAC members

6) Do you think separately presenting income and expenses from financial liabilities with returns that behave like the return on an equity instrument would provide more useful information?

7) Should these income and expenses be presented in other comprehensive income (as proposed) or a separate line item in profit or loss?

8) If other comprehensive income is used, would you prefer to have such gains or losses affect profit or loss when they are realised?

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Classification of financial instruments as liabilities or equity

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Classification requirements of IAS 32

A financial liability is any liability that is:

- a contractual obligation to deliver cash or another financial asset to another entity; […] or
- a contract that will or may be settled in the entity's own equity instruments and is:
  - a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
  - a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments […]

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

Classification approach and 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** **(eg simple bonds)**	**Liability** **(eg shares redeemable at fair value)**
Obligation to transfer economic resources required <u>only at liquidation</u>	**Liability** **(eg cumulative perpetual bonds)**	**Equity** **(eg ordinary shares)**

Potential classification impacts

	IAS 32	Proposed approach
Ordinary bonds	Liability	
Ordinary shares	Equity	
Puttable instruments that meets the exception	Liability presented as equity	
Other shares redeemable at fair value	Liability	Liability with separate presentation in statement of other comprehensive income
Cumulative preference shares (dividends for a stated rate, deferrable but not cancellable)	Equity	Liability
Derivatives to deliver a fixed number of equity instruments for a fixed amount of cash	Equity	
FX rights issue (meets exception under IAS 32)	Equity	Liability with separate presentation in statement of other comprehensive income subject to specific criteria
FX conversion option (into fixed number of shares)	Liability	Liability with separate presentation in statement of other comprehensive income subject to specific criteria

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