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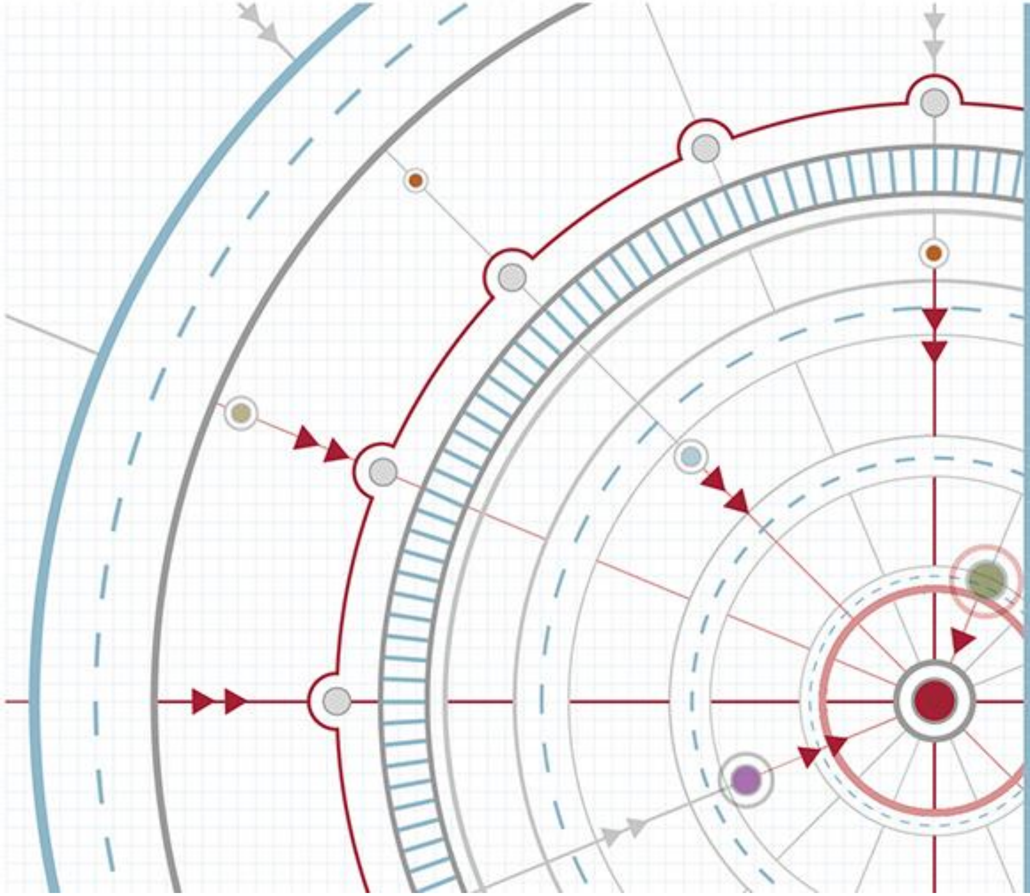

Financial Instruments with Characteristics of Equity

Sue Lloyd, Vice-Chair
International Accounting Standards Board
Singapore, November 2018

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About the project

- Research project
- Project objectives
  - improve the information that companies 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/

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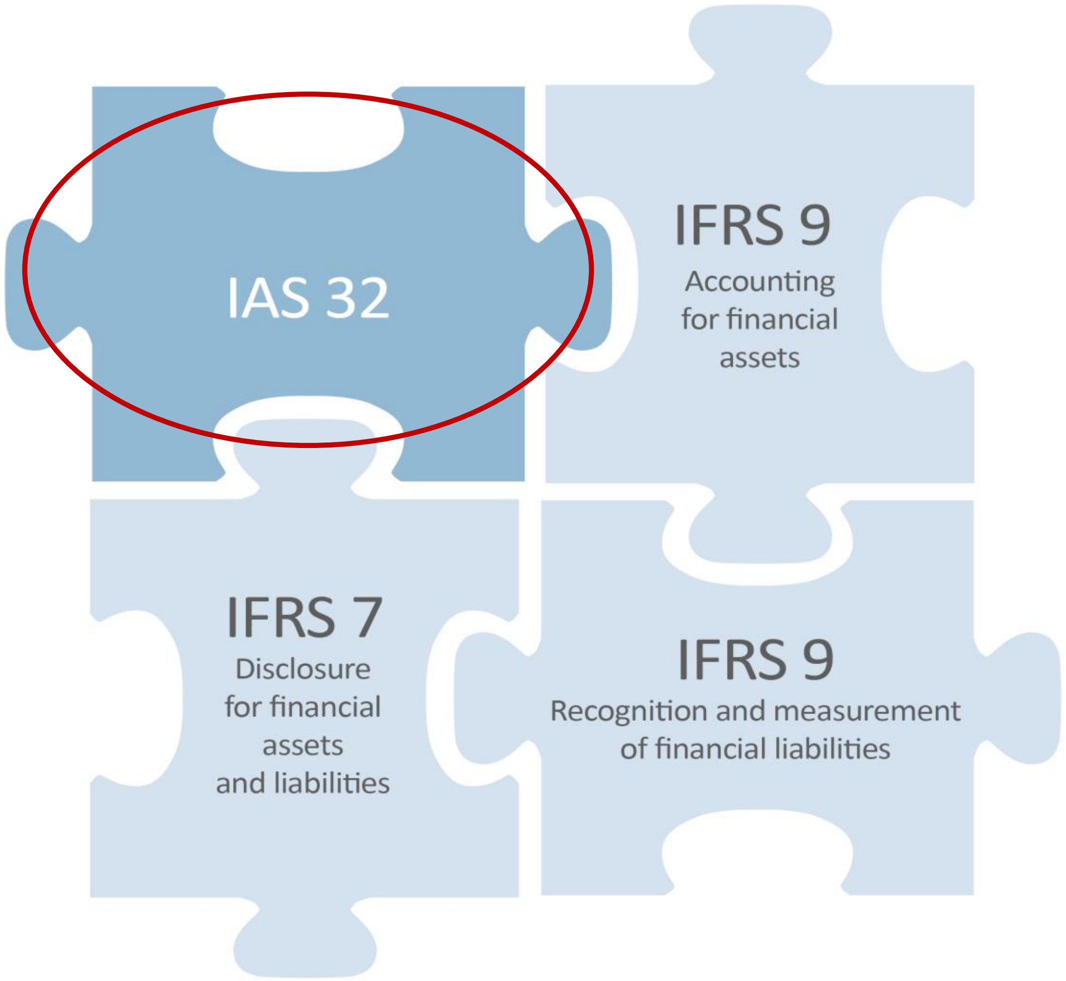
Project scope

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

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 with limited changes to classification outcomes
Growing number of complex financial instruments	Improve the consistency, completeness and clarity of the requirements
Classification can only tell a part of the story	Enhance presentation and disclosure requirements about financial liabilities and equity instruments
Limited information provided for equity instruments	

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

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 hand over cash or 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 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 economic resources required at a specified time other than at liquidation	**Liability** (eg bonds, loans)	**Liability** (eg shares puttable at fair value*)
Obligation to transfer economic resources required only at liquidation	**Liability** (eg cumulative perpetual bonds, share-settled debt)	**Equity** (eg ordinary shares, vanilla warrants)

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

Classification of derivatives: own equity

Application challenges when applying IAS 32

What does ‘fixed’ mean in the ‘fixed-for-fixed’ condition?

Why is there inconsistency between classification of foreign currency options?

The Board’s preferred approach

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:

- it is net-cash settled (the 'timing' feature); and/or
- the net amount of the derivative is affected by a variable that is independent of the entity's available economic resources (the 'amount' feature).

For example,

Receive strike price → Net amount (on settlement) → Deliver own shares

Any independent variables?

FX rate

Gold price

Financial liabilities with equity-like return

The return on some financial instruments behaves like the return on an equity instrument but are classified as financial liabilities because it contains an obligation to transfer economic resources 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.

Presentation - financial liabilities

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

NO

Income statement (profit or loss)	
Income and expenses from financial liabilities that have debt-like return	X/(X)
Profit for the period	XXX

YES

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

Without subsequent reclassification to profit or loss

*The Board's proposal is that separate presentation would also apply to derivative financial assets/liabilities that have the amount feature similar to an equity instrument (ie derivatives with the amount feature that depends on the entity's available economic resources) and particular foreign currency derivatives on own equity subject to specific criteria.

Presentation – equity instruments

Step 1: Start with profit or loss and OCI

Step 2: Non-derivative equity instruments

Present the amount of dividends paid/declared on the face of the statement of financial performance (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 on method

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 (see slide 14)
- 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

Order of priority	As of 1 January 20XX In CU million
Senior secured loan	X
Junior secured loan	X
Subordinated note(s)	X
Total liabilities	XX
Non-cumulative preference shares	X
Ordinary shares	X
Total equity	**XX**
Total capitalisation	**XXX**

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 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 September 20X1 Exercise of warrants	400,000	(400,000)
31 December 20X1	**5,600,000**	**1,100,000**

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