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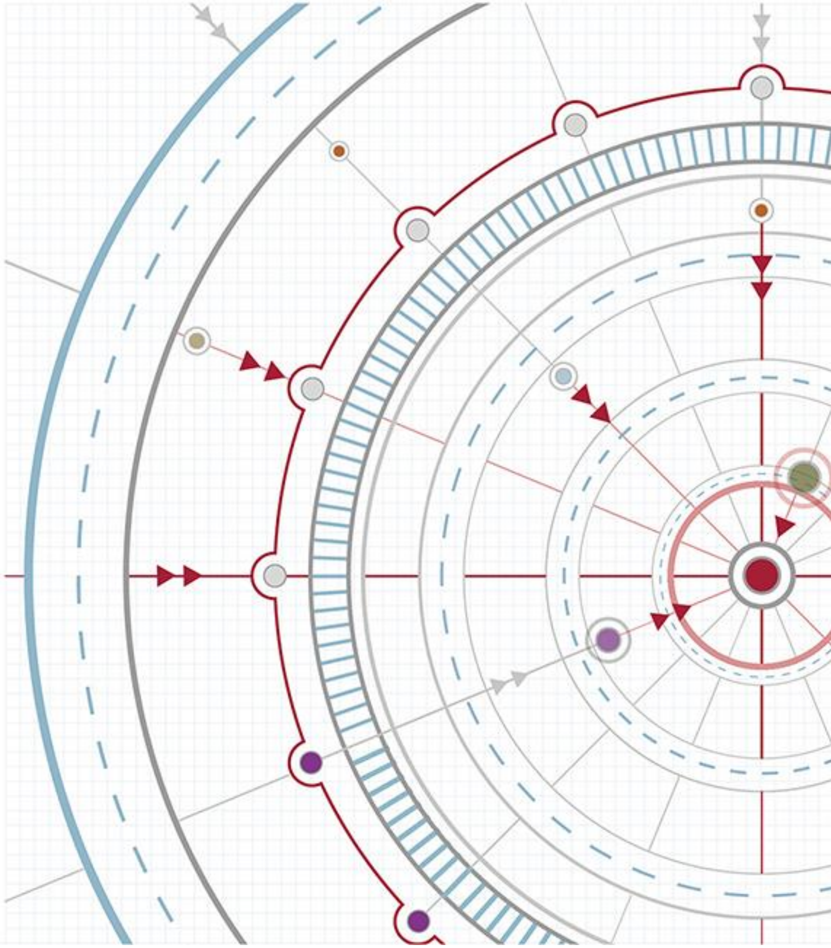

Financial Instruments with Characteristics of Equity

Accounting Standards Advisory Forum meeting
July 2018

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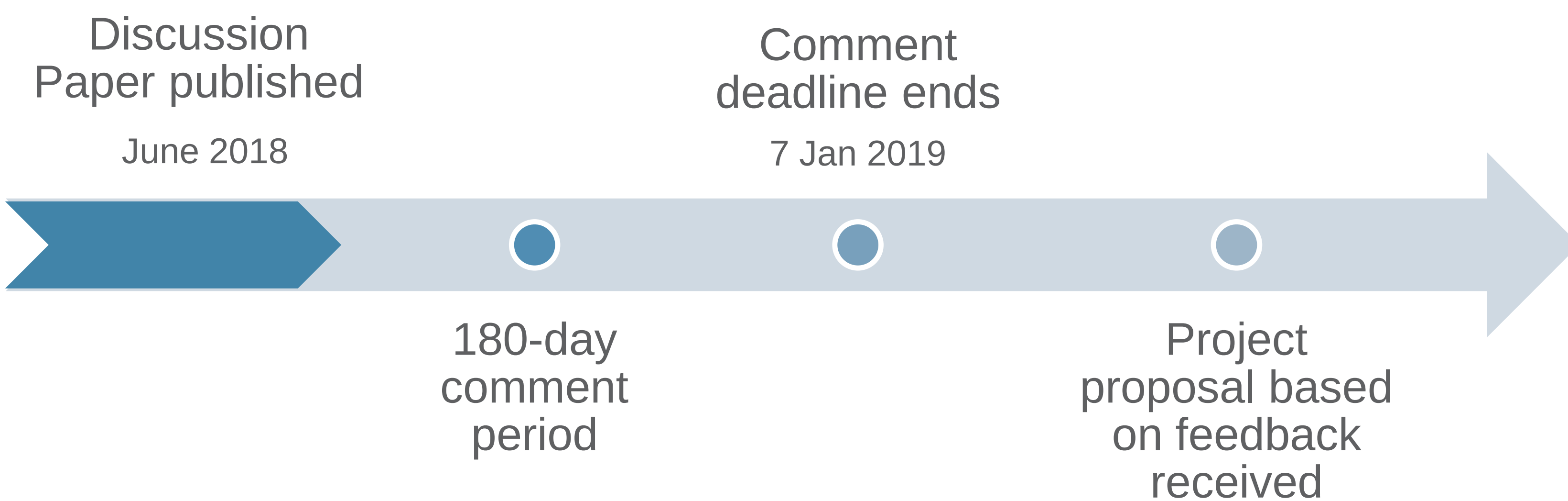
Purpose of this session

- This is an education session on the Discussion Paper *Financial Instruments with Characteristics of Equity* (FICE) to support the ASAF members' outreach activities.
- We are not asking ASAF members to share their views or of the stakeholders in their jurisdictions at this session.

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



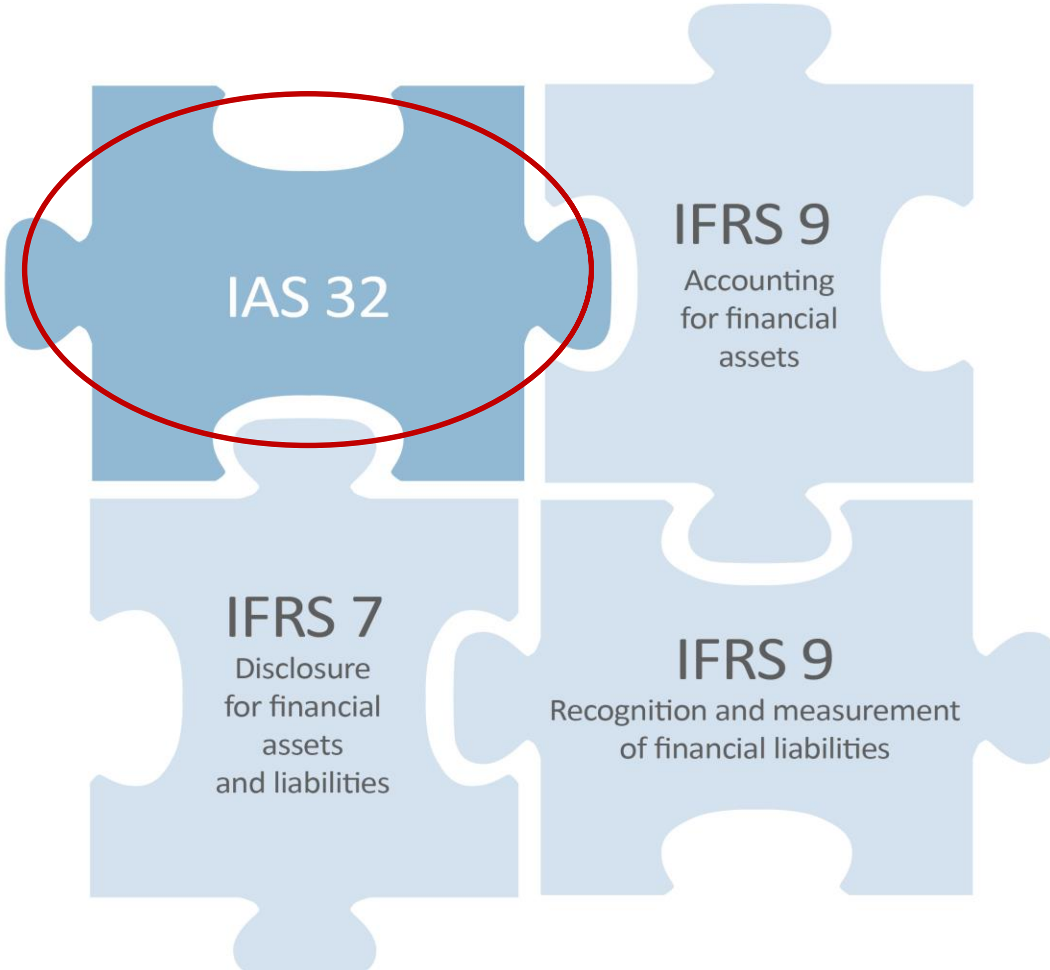
Project scope

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 and IFRS 7



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:

For preparers: a clearer rationale for classification

For investors: provide richer and more comparable information

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 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 a part of the story	• Enhance presentation and disclosure requirements about financial liabilities and equity instruments

Question 1 in the Discussion Paper (DP)*

- Section 1 of the Discussion Paper describe the challenges identified and provide an explanation of their causes.

a) Do you agree with this description of the challenges and their causes? Why or why not? Do you think there are other factors contributing to the challenges?

b) Do you agree that the challenges identified are important to users of financial statements and are pervasive enough to require standard-setting activity? Why or why not?

*All questions included in this presentation pack have often been simplified or paraphrased for presentation purposes.

Section 2 The Board's preferred approach

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

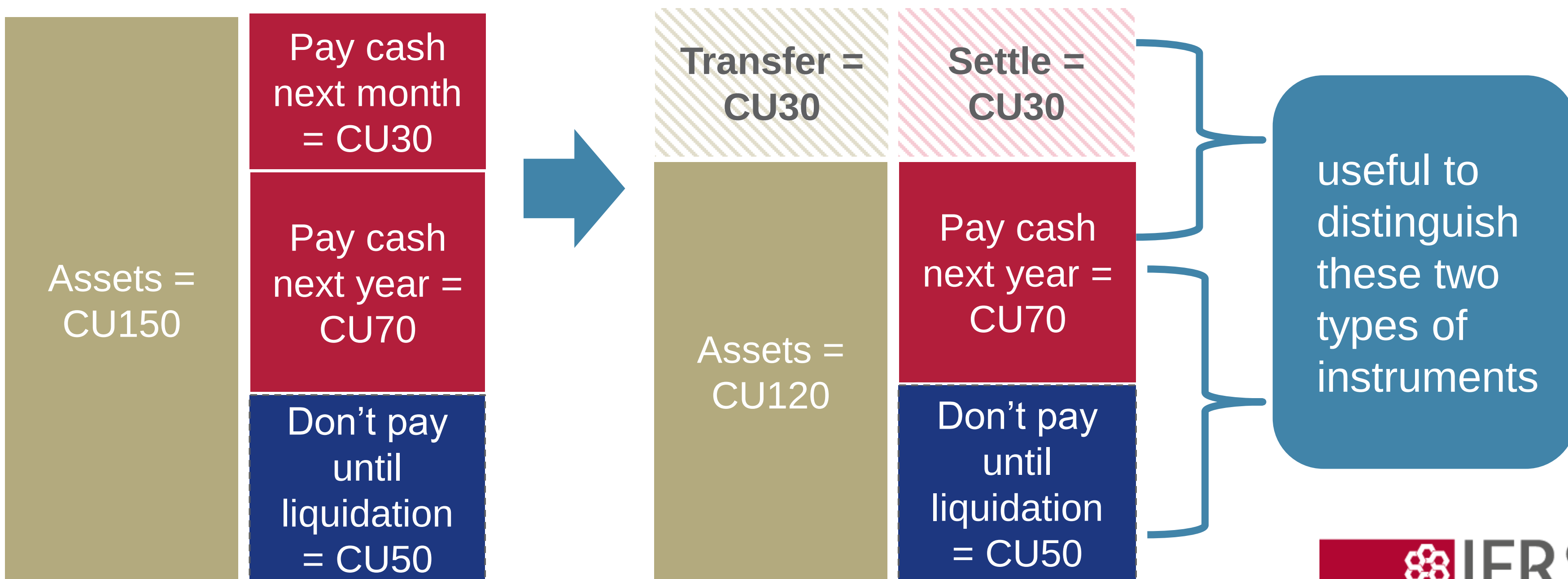
Has the issuer promised a return to the instrument's holder regardless of the issuer's own performance or share price?

Amount feature

Otherwise, it is an equity instrument

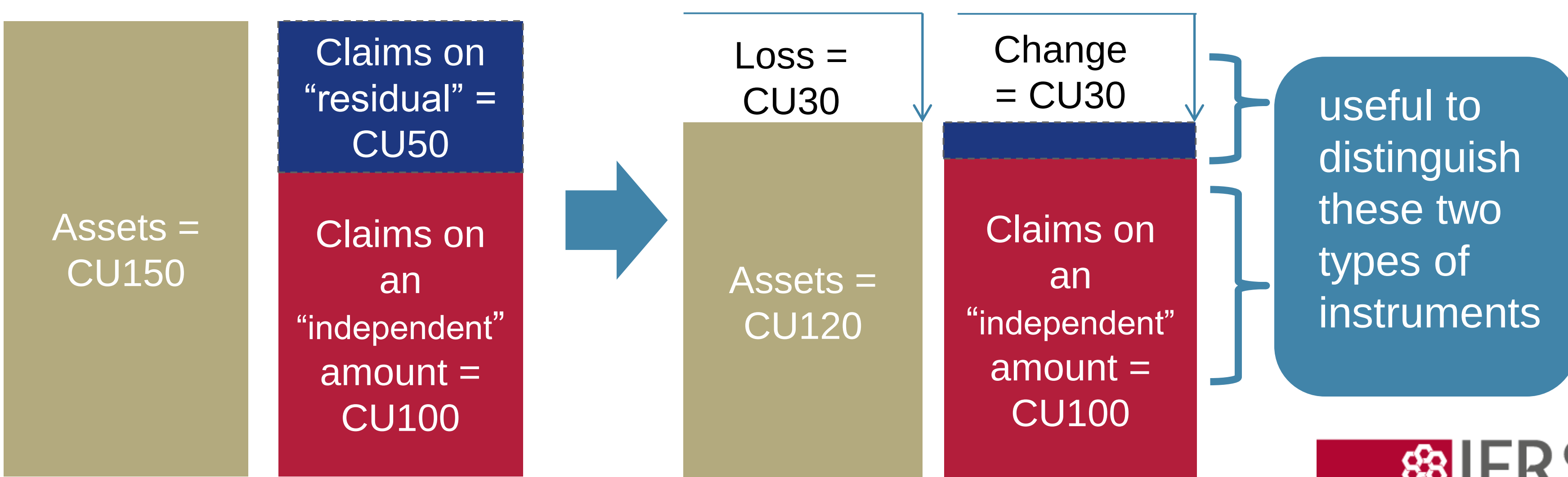
Underlying rationale

- **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)



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Question 2 in the DP

- The Board's preferred approach to classification would classify a claim as a liability if it contains:

  (a) an unavoidable obligation to transfer economic resources at a specified time other than at liquidation; and/or

  (b) an unavoidable obligation for an amount independent of the entity's available economic resources.

  The Board's preliminary view is that information about other features of claims should be provided through presentation and disclosure.

  Do you agree? Why, or why not?

Section 3 Classification of non-derivative financial instruments

Classification 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 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

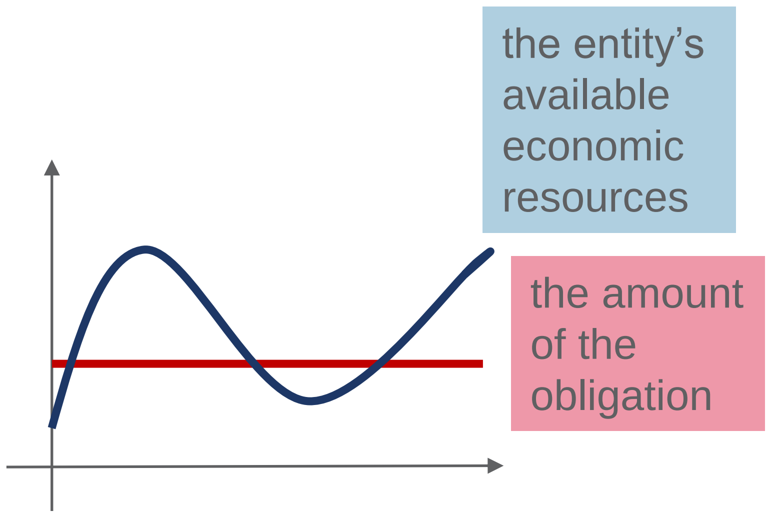
*That do not meet the puttable exception.
No proposals to change the existing puttable exception.

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.

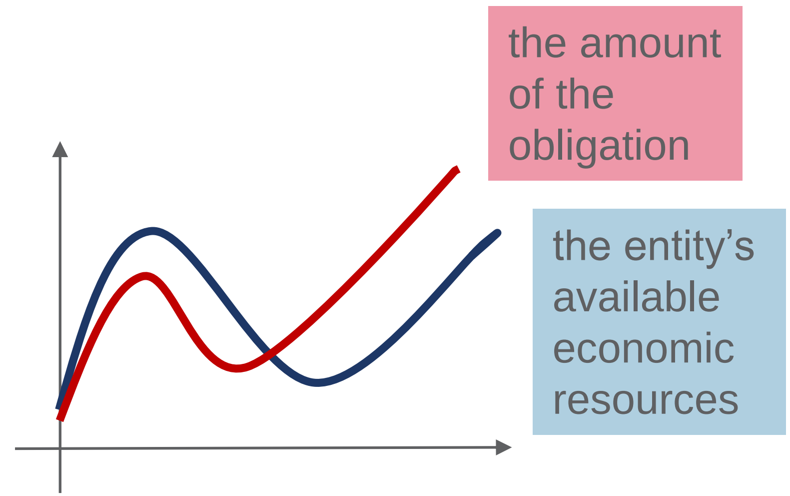
Amount independent of available economic resources (2)

For example,



Does not change

OR



Could exceed

Examples

Examples	An obligation for an amount independent of the entity's available economic resources?
A bond for a fixed amount of cash	• No • The amount of the bond is constant even when the entity's available economic resources change
A bond that entitles the holder to 30% of the value of the entities total assets	• No • The total claims on the entity other than the bond could exceed 70% of total assets

Questions 3 and 4 in the DP

- The Board's preliminary view is that a non-derivative financial instrument should be classified as a financial liability if it contains:

  (a) an unavoidable contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation; and/or

  (b) an unavoidable contractual obligation for an amount independent of the entity's available economic resources.

  Do you agree? Why, or why not?

- The Board's preliminary view is that the puttable exception would be required under the Board's preferred approach. Do you agree? Why, or why not?

Section 4 Classification of derivative financial instruments

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

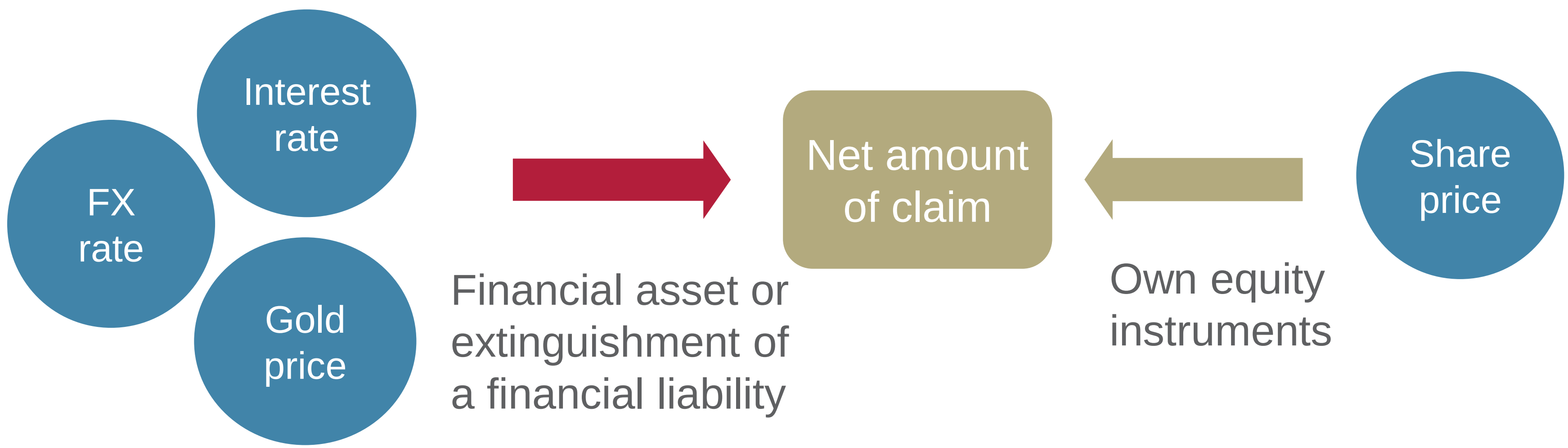
- Tests whether net amount is affected by any “independent variables” - fixed-for-fixed derivatives will continue to be equity
- Principle would clarify that some variables do not preclude equity classification (eg some anti-dilution provisions)

Classification of derivatives: variables

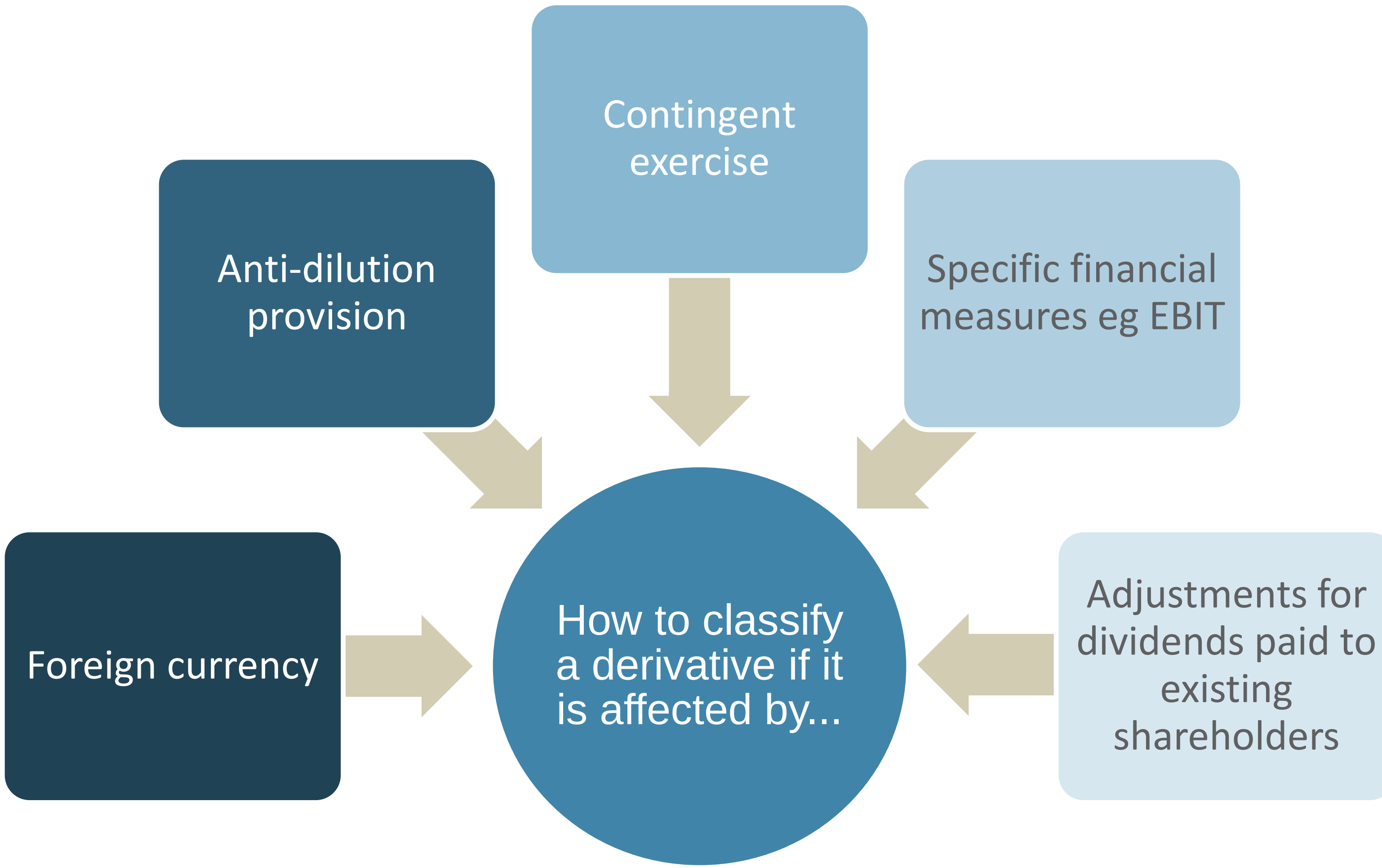
The Board's preferred approach would classify a derivative on own equity as a financial asset or a financial liability if:

(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



Examples of variables

Examples	Is the variable independent of the entity’s available economic resources?
A derivative that requires an entity to deliver a variable number of own shares that represent a 5% of issued shares for a fixed amount of functional currency of the entity	• No • By promising a fixed proportion of the entity’s shares in issue, the net amount of the derivative will only be affected by changes in the entity’s available economic resources.
A derivative that requires an entity to deliver 100 units of own shares subject to an adjustment that will occur in the event of dilution so that the holder receives shares worth at least CU100.	• Yes • Such a contractual term has the effect of the entity promising an amount that is independent of the entity’s available economic resources, CU100, at least in some scenarios.

Question 5 in the DP

- The Board's preliminary view for classifying derivatives on own equity—other than derivatives that include an obligation to extinguish an entity's own equity instruments—are as follows:

  a) a derivative on own equity would be classified in its entirety as an equity instrument, a financial asset or a financial liability; the individual legs of the exchange would not be separately classified; and

  b) a derivative on own equity is classified as a financial asset or a financial liability if:

     i. it is net-cash settled—the derivative requires the entity to deliver cash or another financial asset, and/or contains a right to receive cash for the net amount, at a specified time other than at liquidation; and/or

     ii. the net amount of the derivative is affected by a variable that is independent of the entity's available economic resources?

  Do you agree? Why, or why not?

Section 5 Compound instruments and redemption obligation arrangements

Consistent classification outcomes

- The Board's preferred approach aims to classify consistently all contractual rights and obligations that have similar economic effects on the issuer regardless of how they are structured.

Embedded derivative	Exercise conditional at option of the holder	Extinguishing liability by delivering equity instruments
or	or	or
Standalone derivative	Exercise conditional depending on an uncertain future event	Extinguishing equity instruments in a way that meets the liability definition

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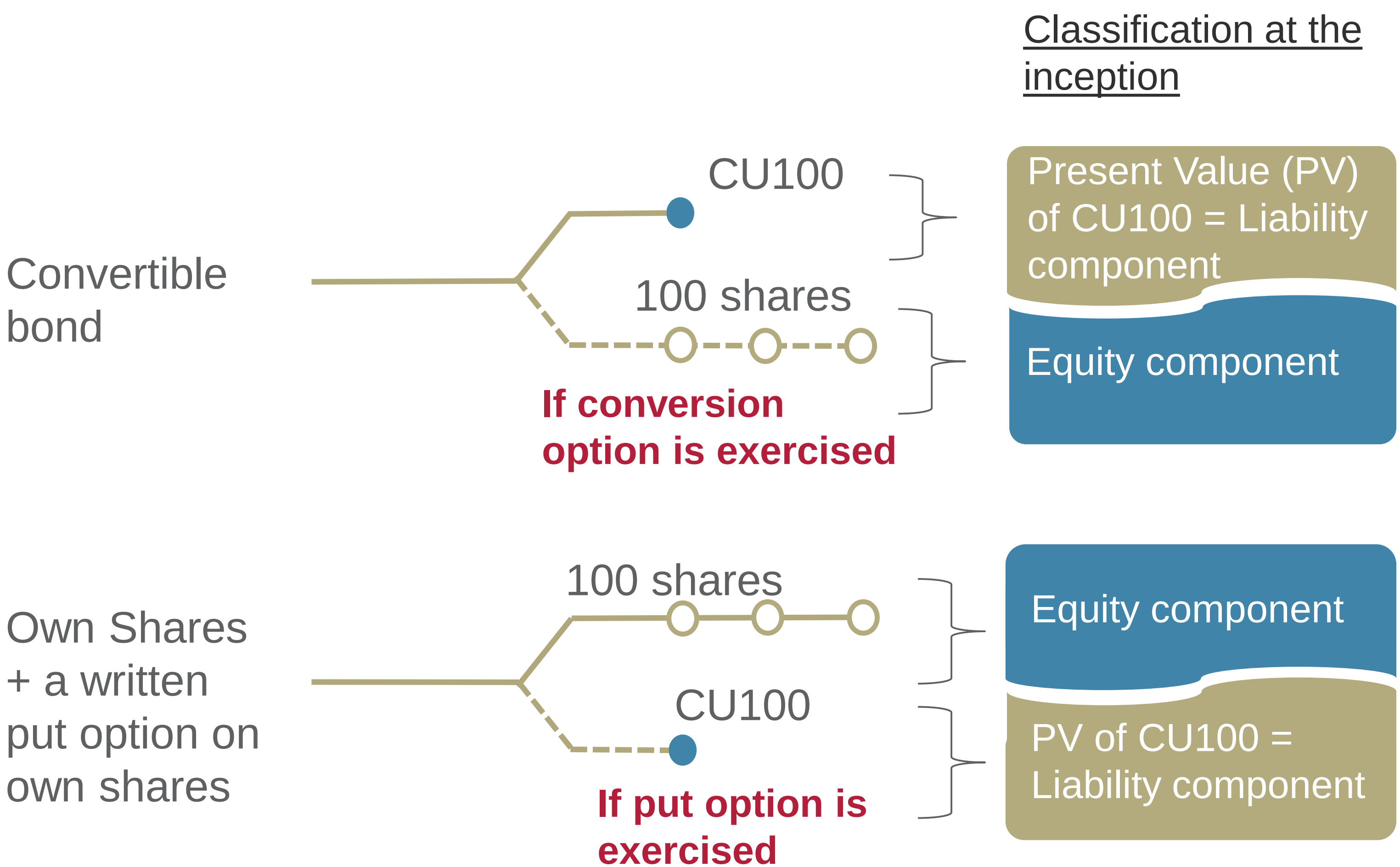
Convertible bonds and written put options



● "independent" amount ○ "dependent" amount

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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?

Clarifications

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
- Classify remaining rights and obligations using derivative principle

If strike price is at fair value, remeasure liability
Separate presentation of income and expense (see slide 37-39)

Question 6 in the DP

- In the Board's preliminary view, applying the Board's preferred approach, an entity would:
  a) for a standalone derivative to extinguish an equity instrument, eg written put option on own shares, consider the package of contractual rights and obligations arising from the derivative and the equity instrument that may be extinguished (together referred to as a 'redemption obligation arrangement').
  b) for a compound instrument or a redemption obligation arrangement, classify separately the financial liability and equity components.

  Applying these preliminary views to a written put option on own shares would result in recognition of a 'grossed-up' financial liability.

  Do you agree with the Board's preliminary view?

Question 6 in the DP (2)

- If a financial instrument contains alternative settlement outcomes that are controlled by the entity, ie the entity has the unconditional right to avoid the liability-settlement outcome (eg a ‘reverse’ convertible bond), the Board’s preferred approach would classify the financial instrument as an equity instrument in its entirety.
- The Board considered possible ways to provide information about the alternative settlement outcomes, which includes separation of embedded derivatives from the equity host instrument and presentation or disclosure requirements(eg attribution within equity).
  - Do you think the Board should seek to address the issue? Why, or why not?
  - If so, what approach do you think would be most effective in providing the information, and why?

Section 6 Presentation

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

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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

Question 7 in the DP

- Do you agree with the Board's preliminary view that an entity should:
  a) in the statement of financial position, present separately the carrying amounts of financial liabilities and derivative financial assets/liabilities that contain no obligation for an amount independent of the entity's available economic resources and some 'partly independent' FX derivatives on own equity subject to specific conditions.
  b) in the statement of financial performance, present in OCI the income and expenses arising from the financial instruments described in (a) without subsequent recycling.
- The Board also considered whether or not it should require separate presentation for all embedded derivatives (including those that are not separated from the host) but did not reach a preliminary view. Do you think it should be required considering the benefits and the costs? Why, or why not?

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 three possible methods

No preliminary view formed

Step 4: ordinary shares

Present the remaining income and expenses attributable to ordinary shares

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

Question 8 in the DP

- The Board's preliminary view is that it would be useful to users of financial statements assessing the distribution of returns among equity instruments to expand the attribution of income and expenses to some equity instruments other than ordinary shares. Do you agree? Why, or why not?
- The Board's preliminary view is that the attribution for non-derivative equity instruments should be based on the existing requirements of IAS 33. Do you agree? Why, or why not?
- The Board did not form a preliminary view in relation to the attribution approach for derivative equity instruments. However, the Board considered various approaches as set out on slide 41. Which approach do you think would best balance the costs and benefits of improving information provided to users of financial statements?

Section 7 Disclosure

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 note(s)	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

Question 9 in the DP

- The Board’s preliminary view is that providing the information described on slide 44 in the notes to the financial statements would be useful to users of financial instruments:

Do you agree with the Board’s preliminary view? Why, or why not?

Section 8 Contractual terms

Economic compulsion

- 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.
- Applying the proposed approach, classify claims such as the callable preferred shares with resets, and cumulative preference shares, 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.
- 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.

Question 10 in the DP

- Do you agree with the Board’s preliminary view that:

  a) economic incentives that might influence the issuer's decision to exercise its rights should not be considered when classifying a financial instrument as a financial liability or an equity instrument?

  b) the requirements in paragraph 20 of IAS 32 for indirect obligations should be retained?

  Why, or why not?

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.

Question 11 in the DP

- The Board’s preliminary view is that an entity shall apply the Board’s preferred approach to the contractual terms of a financial instrument consistently with the existing scope of IAS 32.

  Do you agree? Why, or why not?

Questions?

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