EFRAG
European Financial Reporting Advisory Group

Financial Instruments with Characteristics of Equity

Tuesday 4 December 2018

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#FICE

FRC Financial Reporting Council

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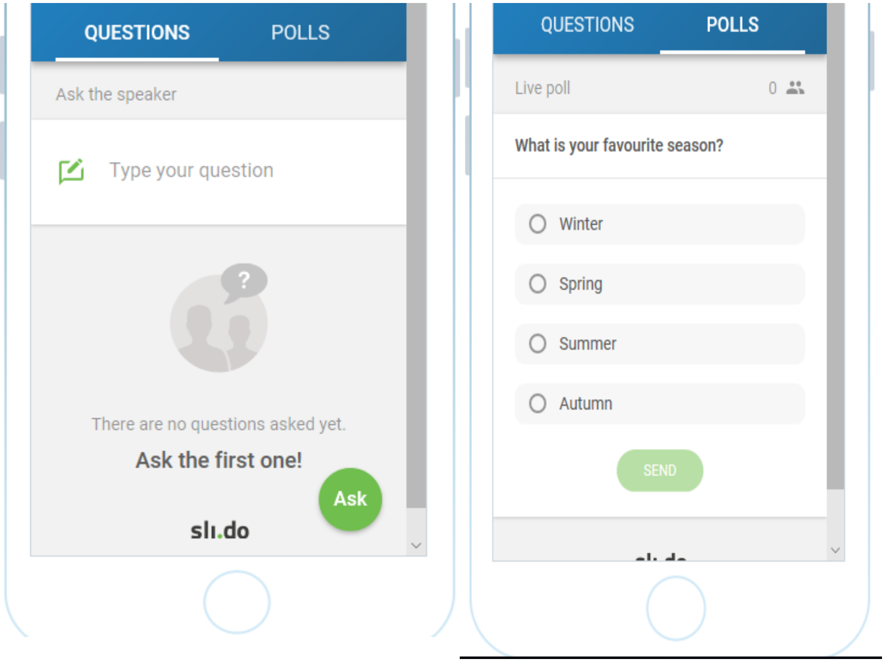
- Pose your question/comments, or answer the polls as the options come up on your phone or tablet screen during the event.



Welcome

Your panel

Chair: Anthony Appleton
Director, Accounting & Reporting Policy, FRC

Andrew Lennard
Research Director, ARPT team, FRC

Alan Chapman
Director
Grant Thornton

Andrew Watchman
Chairman
EFRAG TEG

Introducing DP FICE

Susanne Pust Shah
Project Director
FRC

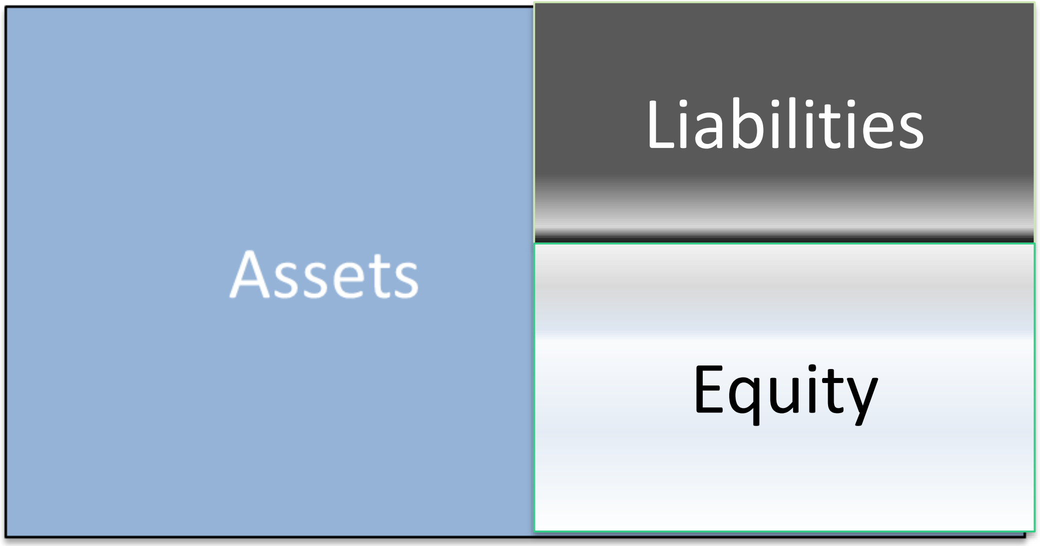
What’s your name?

Discussion Paper:

- **F**inancial **I**nstruments with **C**haracteristics of **E**quity

- “FICE”

What are your interests?



Any famous relatives/friends?

- IAS 32
- Conceptual Framework

How would your friends describe you?

- Provide rationale for classification as liabilities/equity
- No radical changes to classification
- Address practical challenges
- Improve presentation and disclosure

What's your favourite thing about yourself?

Preferred approach would classify a claim as a liability if it contains:

The 'timing' test:

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

The 'amount' test:

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

Note: an amount payable only on liquidation is

- *not relevant for the timing test but:*
- *may cause a claim to be classed as a liability under the amount test.*

Do you think looks are important?

- Separate presentation in statement of financial position
- Also, separate presentation in OCI (Other Comprehensive Income)
  - No recycling to statement of profit or loss
- Presentation by order of priority

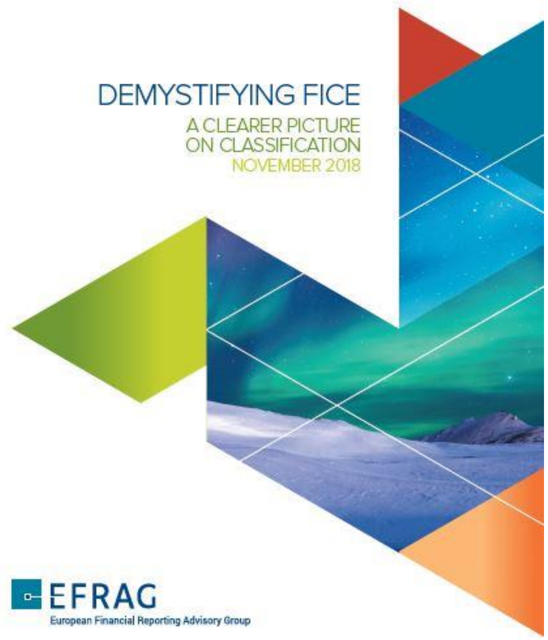
What makes you interesting?

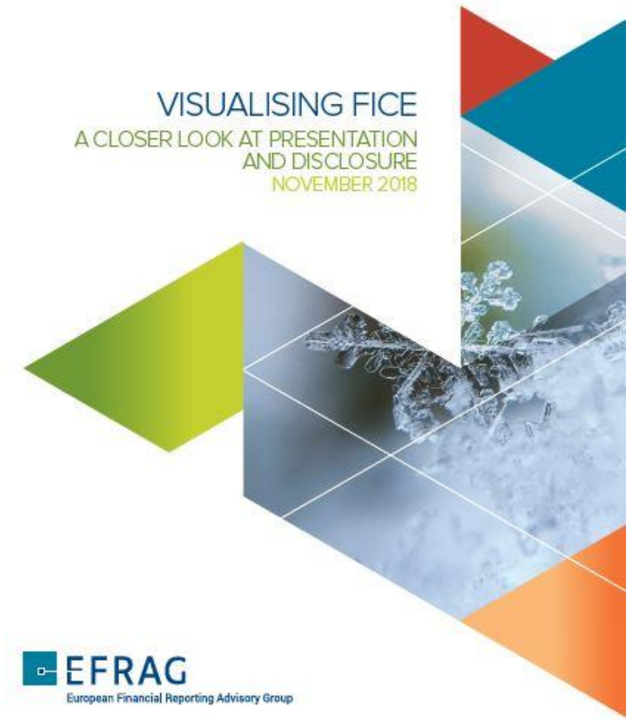
Attribution for equity instruments

- For non-derivatives (other than ordinary shares) use IAS 33 for attribution of total comprehensive income to different classes of equity instruments

- Three different approaches for attribution to derivative equity instruments: all reflect fair value of the derivative or disclosure only

What books can you recommend?





A view from practice

Alan Chapman

Director

Grant Thornton

Financial Instruments with Characteristics of Equity

Alan Chapman

Director, National Assurance Services

Financial Instruments with Characteristics of Equity – key practical observations

Classification and the “amount” test

Measurement aspects arising

Equity presentation and attribution – complexity and cost / benefit

Financial liability presentation - consistency and cost / benefit

Overall FICE approach

Distinction based on amount feature / Distinction based on timing feature	Obligation for an amount independent of the entity's available economic resources (such as fixed contractual amounts, or an amount based on an interest rate or other financial variable)	No obligation for an amount independent of the entity's available economic resources (such as an amount indexed to the entity's own share price)
Obligation to transfer cash or another financial asset at a specified time other than at liquidation (such as scheduled cash payments)	**Liability** (eg simple bonds)	**Liability** (eg shares redeemable at fair value)
No obligation to transfer cash or another financial asset at a specified time other than at liquidation (such as settlement in an entity's own shares)	**Liability** (eg bonds with an obligation to deliver a variable number of the entity's own shares with a total value equal to a fixed amount of cash)	**Equity** (eg ordinary shares)

2.1 – a liability is where either……

"The timing test"

An unavoidable obligation to transfer economic resources at a specified time other than liquidation

"The amount test"

An unavoidable obligation to transfer economic resources for an amount independent of the entity's available economic resources

3.18 – independent of economic resources if

The amount does not change as a result of the entity's available economic resources

The amount changes as a result of the entity's available economic resources but does so in a way that the amount could exceed the available economic resources of the entity

Some scenarios (all equity in IAS 32)

Pref shares issued for £1000. Discretionary dividends cumulative at 5% per annum.	FICE model
Cumulative preference shares issued for £1000. Discretionary dividends of 5%. £1000 plus "accrued" unpaid amounts due on liquidation	Debt in FICE
Non cumulative preference shares issued for £1000. Discretionary dividends of 5%. £1000 due on liquidation	Compound per FICE- £1000 due on liquidation is a debt component – Appendix D says fair value negligible on going concern basis ?
A ordinary shares. On liquidation gets first £20M in a waterfall then later pro-rata?	Compound per 3.19 ? £20M on liquidation = debt component. How is debt valued ?

Derivative over own equity

IAS 32

Fixed for fixed test

FICE

Considers whether the net amount is affected by any independent variables (ie is it affected by anything other than share price)

Clarifies position on anti-dilution provisions

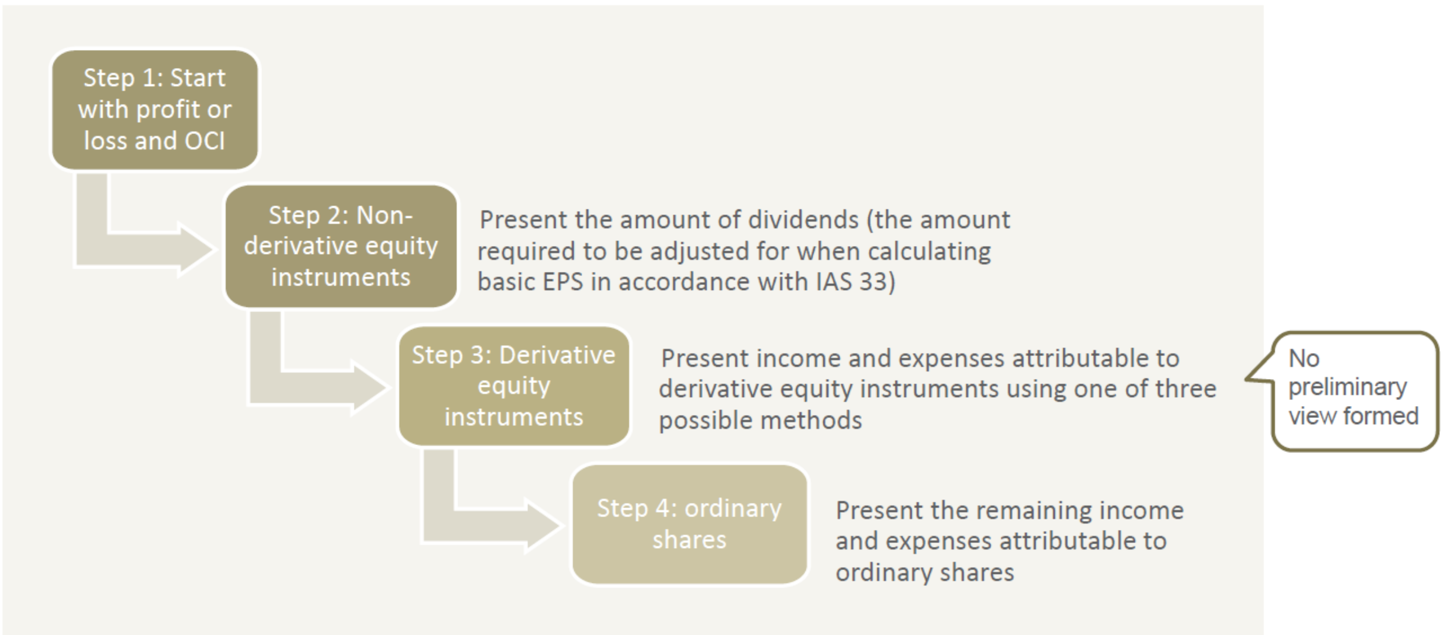
Derivatives over own equity

	IAS 32	FICE
Warrant to issue 100 shares in exchange for CU 100 cash (holder option)	Equity	Equity
Warrant to net cash settle instrument above	Liability	Liability
Warrant to issue 100 shares in exchange for foreign currency 100	Liability (subject to rights issue exception)	Liability
Warrant to issue 5% of shares in exchange for CU 100	Judgemental – most GAAP texts consider liability	Equity
Warrant to issue 100 shares for CU100. However, value of shares delivered a minimum of CU 100	IAS 32 did not specifically comment – in our view a financial liability	Liability

Obligations to repurchase own equity

	IAS 32	FICE
Written put to repurchase 100 equity shares in exchange for CU100 cash	Gross financial liability for present value of the redemption amount and reclassify from equity	Gross financial liability for redemption amount. Derecognise equity at current fair value and recognise the residual (for call option) in equity

Presentation of equity instruments



Attribution of derivative equity instruments

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

Presentation of financial liabilities - separate balance sheet presentation and gains or losses included in OCI (no recycling)

Liabilities that contain no obligation for an amount that is independent of the available economic resources	Eg puttable at fair value
Derivatives that have net amounts unaffected by any independent variable	Eg derivative to settle 100 shares vs CU100 – settled net in cash
Partly independent derivatives meeting specific criteria (foreign currency)	Call option to issue 100 shares in exchange for FC100

Do proposals address current concerns ?

Issue	Impact
Derivatives over own equity	Proposals provide a principle behind “fixed for fixed”
Mandatory tender offers	Similar to IAS 32, FICE only considers contractual obligations not statutory obligations
Written puts	Similar to IAS 32 FICE carries gross obligation – but derecognises equity
Written puts over NCI	Similar to IAS 32 carries gross obligation. At initial recognition. NCI equity derecognised. Movement will go through profit and loss unless puttable at fair value (OCI)

Do proposals address current concerns ?

Issue	Impact
Written puts over NCI settled by a variable number of parents own shares (IFRS IC Nov 2016)	If amount of shares is determined by a fixed amount independent of the entity’s resources then would be a financial liability
Instruments where manner of settlement is conditional on rights within the control of the entity (eg dividend step up clauses, reverse convertible bond)	Similar to IAS 32, economic compulsion does not give rise to a financial liability. But amount test would impact some. Indirect obligations retained
Contingent settlement obligations	IAS 32.25 requirements carried forward. FICE has not specifically addressed issue of what is within the entity’s control (eg settlement on IPO)
Mandatorily convertible into a variable number of shares upon a contingent non viability event	Similar to IAS 32 only contractual provisions included. If has a contractual obligation, in identifying liability component do not consider uncertainty from conditionality

Do proposals address current concerns ?

Issue	Impact
Mandatorily convertible into a variable number of own shares subject to a cap and floor (IFRS IC May 2014)	Obligation to issue a variable number of shares equal to a fixed amount is a non-derivative liability component. Remaining rights classified under derivative approach. Similar to IFRS IC decision
Payments at the ultimate discretion of the issuers shareholders	Not dealt with
Requirements which led to counter-intuitive financial reporting	In some cases (eg puttable at fair value) would go to OCI. However potential for perceived inconsistency

Tentative FRC views

Andrew Lennard

Research Director

FRC

Main points

- Points of agreement
- Scope of the project
- Classification criteria (especially the ‘amount’ test)
- Attribution to different equity interests

Points of agreement

- Binary distinction between liabilities and something else should be maintained
- No binary distinction is adequate in itself: supplementary disclosure is required
- ‘Timing’ (obligation) and ‘amount’ ideas are highly significant

Scope:

'If a job's worth doing…'

- DP aims to rationalise existing requirements, but
  - new terminology and complexity
- A fundamental review would be welcome
  - Not convinced by arguments either that:
    - Existing requirements are working well; or
    - Fundamental review would require excessive changes
  - subject to other agenda priorities
- Alternatively, focus on disclosure and presentation

Classification

- Combination of timing and amount test minimise the claims that are reported as equity
  - But should this be the objective?
- Amount test
  - Departs from Conceptual Framework (no present obligation to transfer an economic resource)
  - Is the source of much complexity
  - Perhaps should drive disclosure/presentation rather than classification
  - Amounts payable only on liquidation are relevant

The ‘fixed for fixed’ conundrum

- An obligation to issue a number of shares worth £1,000 ‘feels like’ a liability
  - Amount test secures this—but is it right?

Possible alternative solutions:

a) Define a liability as including an obligation to issue/transfer shares
  - Change to long-standing view that own shares are not an economic resource
  - Implies ‘conventional’ options are liabilities too—so changes in value will be reported in comprehensive income

b) Focus on claim existing at the balance sheet date
  - Method of settlement is not determinative
  - Consistent with (liability component of) convertible bonds and performance obligations (IFRS 15)
  - Might leave some claims classified as equity?

Attribution of comprehensive income to classes of equity

Proposals

- Non-derivatives—use IAS 33 rules
- Derivatives—use one of the following (example from the Discussion Paper)

	Warrants	Ordinary shares	Total
Full fair value approach	**4,120**	**12,299**	**16,419**
Average-of-period approach	**2,447**	**13,972**	**16,419**
End-of-period approach	**(5,558)**	**21,977**	**16,419**

But…

- Do financial statements reflect market fair values of securities?
- If a share of ‘performance’ benefits warrant holders, is this at the expense of ordinary shareholders?

Andrew Watchman

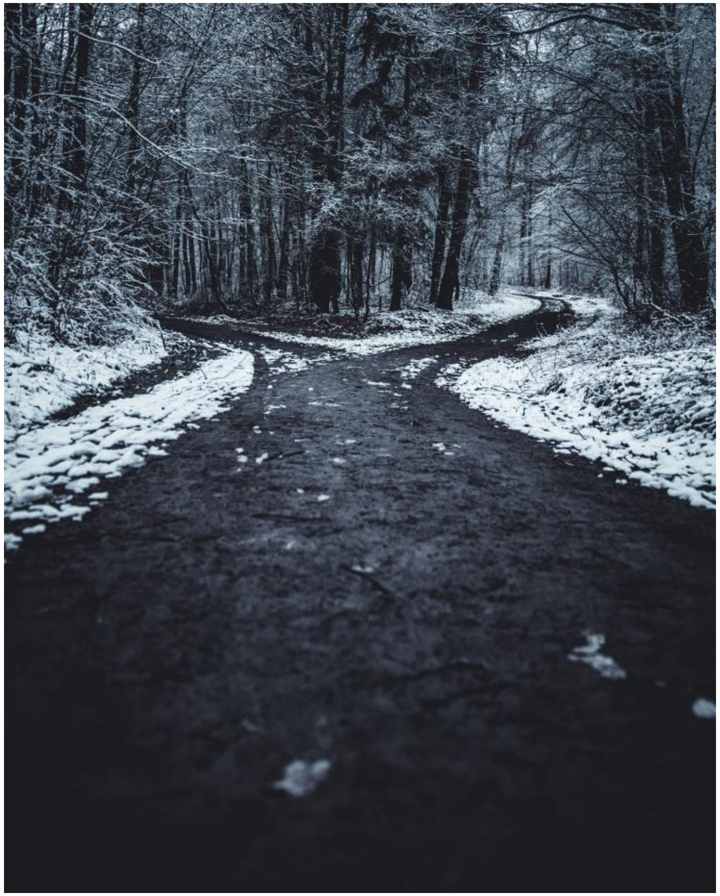
Chairman

EFRAG TEG

DEBT OR EQUITY: How would you decide?

JOINT EFRAG-FRC OUTREACH EVENT

London, 4 December 2018



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EFRAG ACTIVITIES ON FICE

OUTREACH ACTIVITIES AND EARLY-STAGE IMPACT ANALYSIS

- EFRAG published its Draft Comment Letter on FICE on 28 August 2018 (open for comment until 3 December 2018)
- During the consultation period, EFRAG is working on:

Outreach events	Obtain views of European stakeholders
Surveys (open to 30 November)	Gather data on the expected effects and costs/benefits of the IASB's new approach
Bulletins	Help stakeholders understand the IASB's discussions with the use of simplified language and practical examples
Videos / Webinars	Engage with our constituents more broadly
Early stage impact analysis	Understand the real-world consequences of IASB's suggestions in the DP

IS IAS 32 'BROKEN'?

FOR MOST FINANCIAL INSTRUMENTS IAS 32 WORKS WELL…**BUT:**

IAS 32 is 'rule-based' in some areas, has been amended and interpreted several times and includes various exceptions to its general approach

The IFRS Interpretations Committee received several questions on the application challenges of IAS 32 (e.g. derivatives on own equity)

Financial innovation has been stretching the current requirements to their limits (e.g. contingent convertible bonds) and there is a need to 'future proof' IAS 32

Differences from applying the definition of a financial liability in IAS 32 compared to applying the definition of a liability in the Conceptual Framework

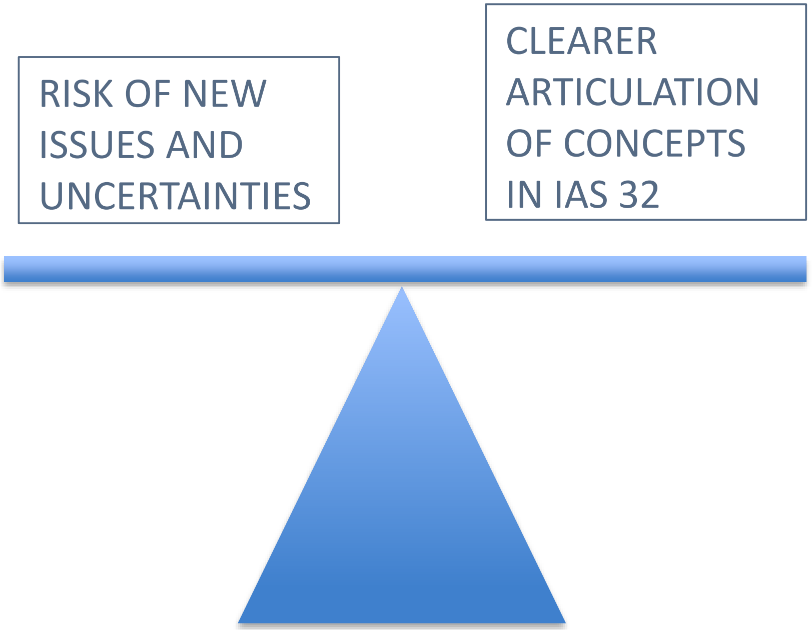
CLASSIFICATION – NON-DERIVATIVE INSTRUMENTS

IASB PROPOSALS

- 'Timing' and 'Amount' features to distinguish debt from equity
- ***Objective:*** clearer, more principle-based compared to IAS 32 but without causing widespread changes in classification outcomes (but there will be some changes)

EFRAG'S TENTATIVE VIEW

- Clearer articulation (than IAS 32) has potential benefits and proposals help with existing interpretive issues
- But would also cause some disruption and risk of new issues and uncertainties
- Are the classification changes (e.g. cumulative preference shares moving from equity to liability) improvements on IAS 32?



CLASSIFICATION – EXCEPTIONS

IASB PROPOSALS

Exceptions to general classification model	**IAS 32**	**DP**
Puttable instruments exception	✓	✓
Obligations arising on liquidation	✓	✓
Foreign currency rights issue exception	✓	✘
Members' shares in co-operative entities (IFRIC 2)	✓	✓

EFRAG’S TENTATIVE VIEW

- Support retaining exceptions for ‘puttables’, obligations on liquidations and co-operatives
- Not convinced by DP’s arguments for eliminating exception for foreign currency rights issue

PRESENTATION – LIABILITIES

IASB PROPOSALS

- Separate presentation in other comprehensive income (OCI) of income/expense on certain liabilities with an ‘equity-like’ return
    - No ‘recycling’ on derecognition
- Separate balance sheet presentation of sub-classes of liability based on whether promised return is dependent/independent of issuer’s economic resources

EFRAG’S TENTATIVE VIEW

- IASB proposal leads to the increased use of OCI which is reserved for ‘exceptional circumstances’ as per the new Conceptual Framework
- Consider recycling from OCI when the financial instruments are realised
- If retained, the scope of the OCI presentation proposal needs fine-tuning

PRESENTATION – EQUITY INSTRUMENTS

IASB PROPOSALS

- Attribution of total comprehensive income among certain subclasses of equity instruments aimed at providing better information on wealth-transfer effects

EFRAG'S TENTATIVE VIEW

- Attribution of comprehensive income will increase complexity while usefulness of resulting information is questionable
- Recommends that IASB improves:
  - existing presentation requirements
  - IAS 33 *Earnings per Share* about dilution information
  - disclosures

DISCLOSURES

IASB PROPOSALS

- Additional information on:
  - Priority of claims on liquidation
  - Potential dilution of ordinary shares
  - Terms and conditions of financial instruments

EFRAG'S TENTATIVE VIEW

- Support targeted disclosure improvements but some of the proposals need further deliberation e.g.
  - Priority on liquidation is based on legal entities – practicable on consolidation?
  - Scope of potential dilution disclosures should not overlap with EPS disclosures

CONTRACTUAL TERMS

IASB PROPOSALS

- As with IAS 32, classification is based on the substance of the contractual terms without considering ‘economic compulsion’ or effects of legislation
- Indirect obligations are considered, e.g. if the issuer can avoid transferring cash only by issuing own shares to a significantly higher value

EFRAG’S TENTATIVE VIEW

- Support retaining IAS 32’s focus on the substance of the contractual terms (such that law and economic incentives are not considered in the classification)
- Some practical issues arise in distinguishing the effect of the contract and the effect of the legislation e.g. for ‘bail-in’ instruments

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Picture on cover by Oliver Roos

THANK YOU

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Poll questions

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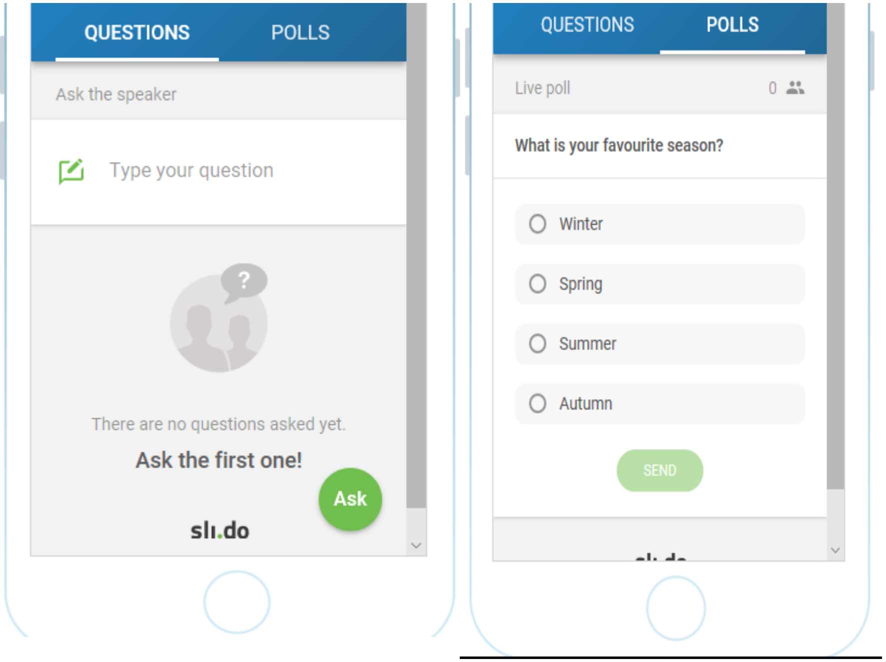

Poll Question 1

The 'timing' test:

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

The 'amount' test:

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

Do you agree that a claim should be classified as a liability if it meets either of the above tests?

Poll Question 2

The proposals of the Discussion Paper would lead to some changes to the classification of claims. For example:

- Irredeemable cumulative preference shares
  - Equity under IAS 32; liability under the Discussion Paper's proposals
- Net-share settled derivative requiring the issue of a fixed number of shares for a fixed amount of cash
  - Liability under IAS 32; equity under the Discussion Paper's proposals

Are these changes appropriate?

Poll Question 3

Do you agree that a change in the amount of a claim that is reported as a liability and reflects the performance of the entity should be reported in other comprehensive income (OCI)? If so, do you agree that they should not be recycled to profit or loss?

Poll Question 4

Do you agree that it would be helpful to users of financial statements to attribute comprehensive income to different classes of equity instruments, including, for non-derivative instruments, by reference to their fair value?


Thank You