

Financial Instruments with Characteristics of Equity

Webinar 2: The Board's preferred approach and classification of non-derivative financial instruments
July 2018

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Financial Instruments with Characteristics of Equity – Webinar Schedule

Previous Webinars

Overview of the Discussion Paper

This Webinar

The Board's preferred approach and classification of non-derivative financial instruments

Future webinars

Classification of derivatives on own equity

Classification of compound instruments and redemption obligation arrangements

Presentation of equity instruments

Presentation of financial liabilities

Overview of the Board's preferred approach

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What analyses are users trying to do?

Funding liquidity and cash flows (Timing feature)

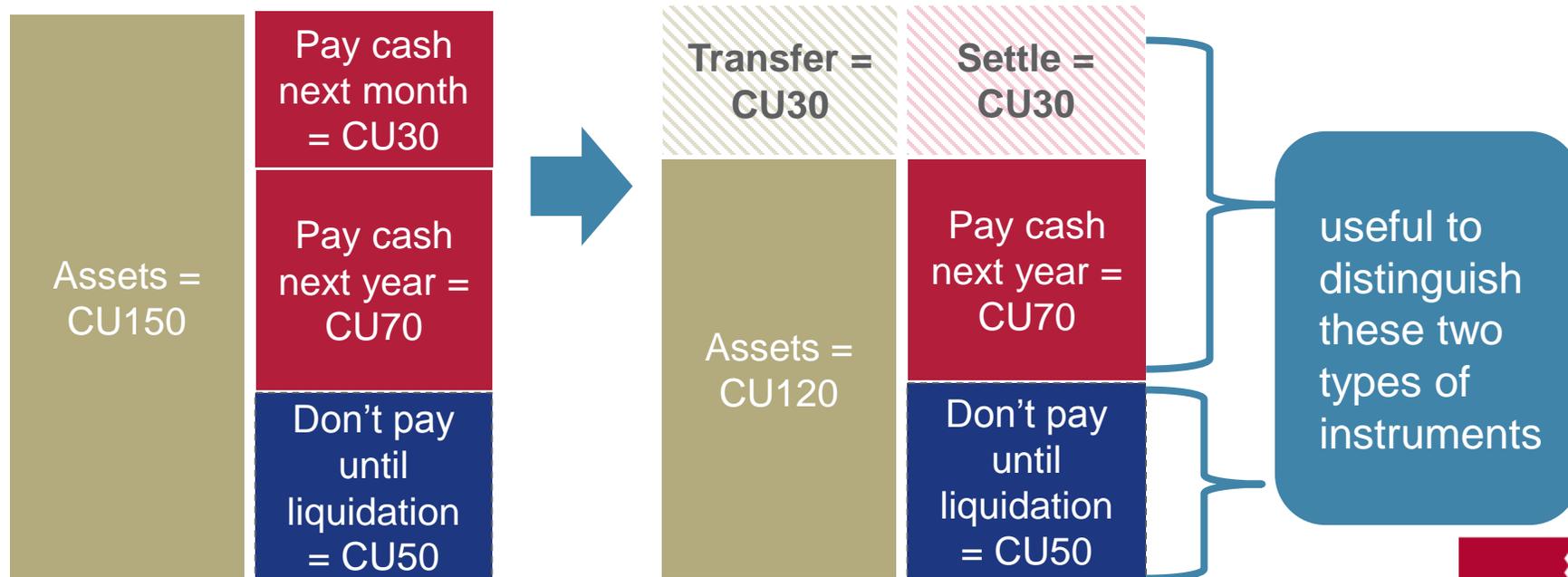
- Depends on information about an entity's obligations to transfer cash or other financial assets at particular points in time

Balance-sheet solvency and returns (Amount feature)

- Depends on information about the AMOUNT of an entity's obligations at particular points in time and
- Whether the entity has produced a sufficient return to satisfy its promised payments

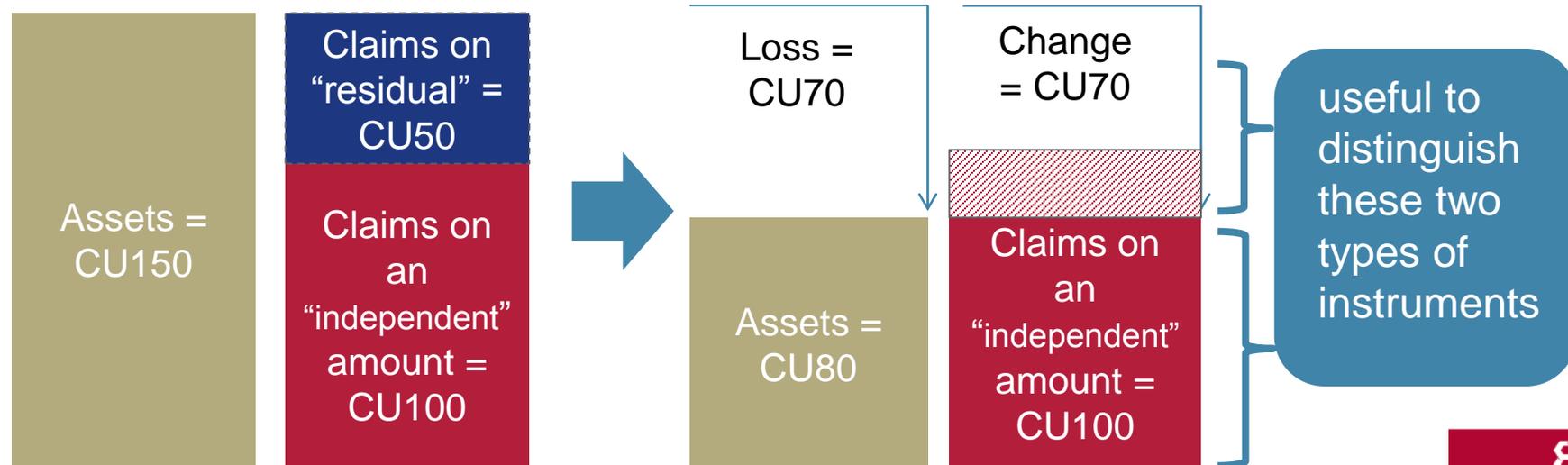
Funding liquidity and cash flows

- **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)



Balance-sheet solvency and returns

- **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 available economic resources
 - financial leverage and flexibility (eg interest coverage, leverage ratio)



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 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

The Board's preferred approach

Amount feature	Contains obligation for <u>an amount independent of the entity's available economic resources</u>	Contains <u>no</u> obligation for an amount independent of the entity's available economic resources
Timing feature		
Obligation to transfer of economic resources required at a specified time other than at liquidation	Liability	Liability
Obligation to transfer of economic resources required <u>only at liquidation</u>	Liability	Equity

The Board's preferred approach

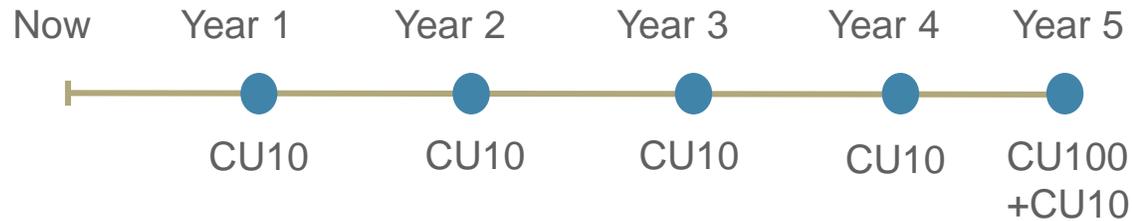
- Some liabilities will have features that are relevant for one but not the other assessment
 - for these liabilities the board considered providing information through separate presentation
- For features that are not captured through classification, the Board considered separate presentation and disclosure requirements to provide better information about
 - Equity instruments
 - Dilution and priority

Application of the Board's preferred approach to non-derivative financial instruments

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Example #1

An entity issues an instrument for CU100 today, the instrument contains an obligation to pay a coupon of CU10 for 5 years and repay the principal amount of CU100 at the end of Year 5.



Should it be classified as liability or equity?		
Timing Feature	Any obligation to transfer cash before liquidation?	✓
Amount Feature	Return on instrument independent?	✓

Example #2

An entity issues an instrument for CU100 today, the instrument contains an obligation to issue 110 own shares in 1 year.



Should it be classified as liability or equity?		
Timing Feature	Any obligation to transfer cash before liquidation?	X
Amount Feature	Return on instrument independent?	X

Example #3

An entity issues an instrument for CU100 today, the instrument contains an obligation to issue a variable number of shares with a total value equal to CU110.



Should it be classified as liability or equity?

Timing Feature	Any obligation to transfer cash before liquidation?	
Amount Feature	Return on instrument independent?	

Example #4

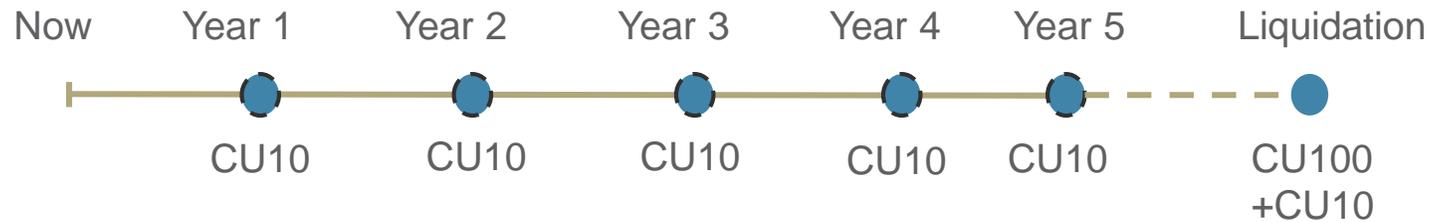
An entity issues a share for CU100 today, the share contains an obligation to buy back the share in 1 year for its market price in cash.



Should it be classified as liability or equity?		
Timing Feature	Any obligation to transfer cash before liquidation?	✓
Amount Feature	Return on instrument independent?	✗

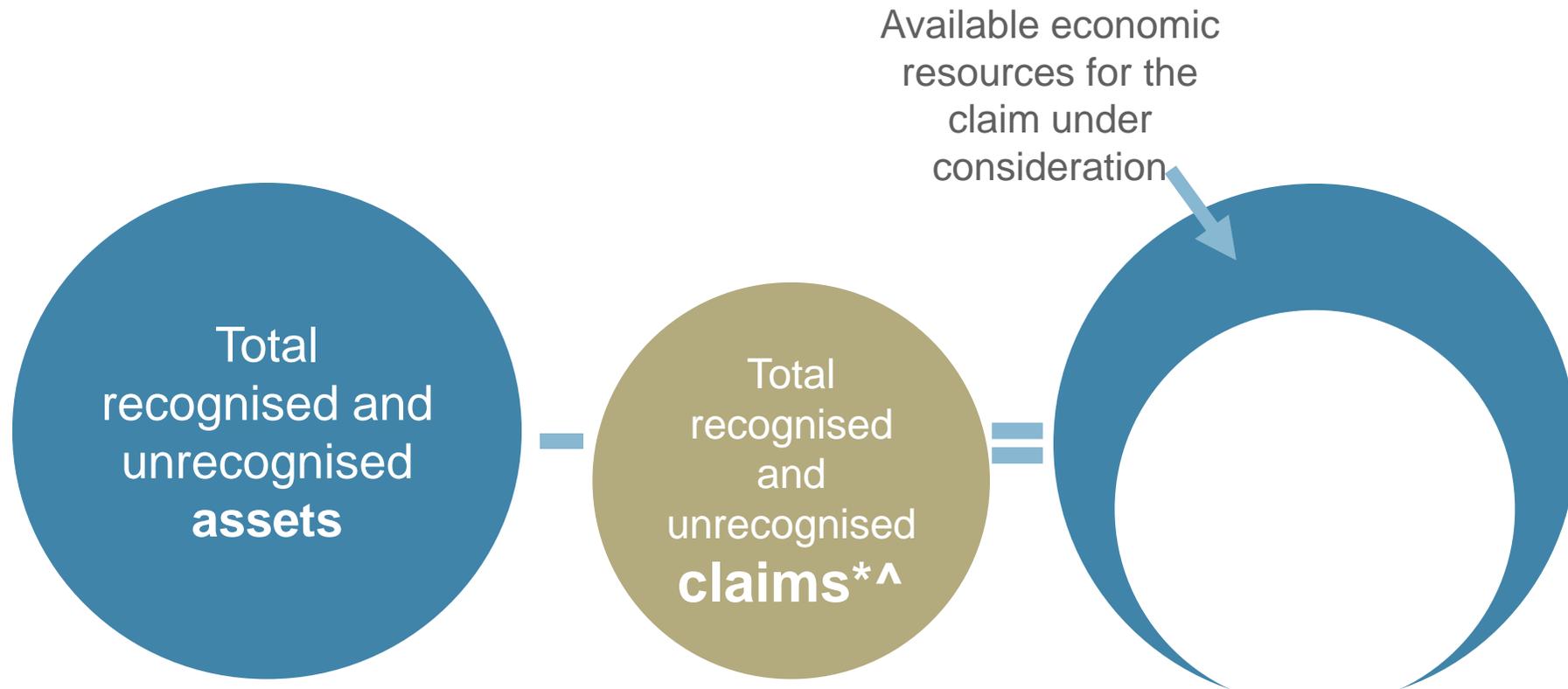
Example #5

An entity issues an instrument for CU100 today, the instrument contains an obligation to pay interest at 10% per year and repay the principal amount of CU100 at liquidation. The entity has the discretion to defer payment of interest indefinitely until liquidation, however unpaid interest accumulates until paid.



Should it be classified as liability or equity?		
Timing Feature	Any obligation to transfer cash before liquidation?	
Amount Feature	Return on instrument independent?	

Available economic resources?



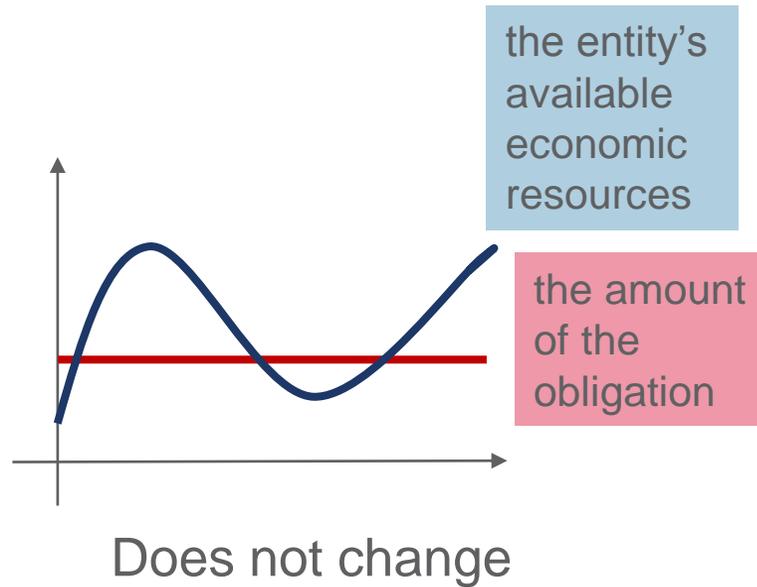
*Claims include all liabilities and equity instruments of the entity
^except for the financial instrument in question

Amount independent of available economic resources

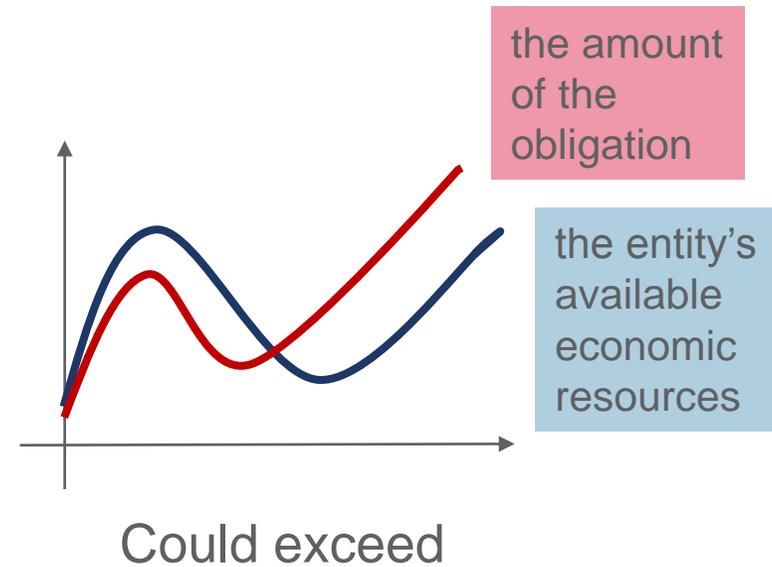
- An amount is independent of the entity's available economic resources if:
 - the amount does not change as a result of changes in the entity's available economic resources; or
 - the amount changes as a result of changes in the entity's available economic resources but does so in such a way that the amount could exceed the available economic resources of the entity.

Amount independent of the entity's available economic resources?

For example,



OR



Example #6

An entity issues an instrument for CU100 today, the instrument has to be redeemed for cash in 1 year at a value equal to 30% of the total assets of the entity at that point in time.



Should it be classified as liability or equity?

Timing Feature	Any obligation to transfer cash before liquidation?	✓
Amount Feature	Return on instrument independent?	✓

- In this webinar we introduced the Board's preferred approach to classification, presentation and disclosure
- We also illustrated the application of that approach to the classification of some non-derivative financial instruments
- In future webinars we will explore the application of the Board's preferred approach to the classification of more complex instruments, and discuss presentation and disclosure

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Future webinars

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