Financial Instruments with Characteristics of Equity

Webinar 6: Presentation of financial liabilities
August 2018
Before we start

• You can download the slides by clicking on the link below the slides window
• This webinar is a recording (it is not live), so we are unable to take any questions
• The views expressed are those of the presenters, not necessarily those of the International Accounting Standards Board (the Board) or IFRS Foundation
## Financial Instruments with Characteristics of Equity – Webinar Schedule

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<td>Classification of compound instruments and redemption obligation arrangements</td>
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<table>
<thead>
<tr>
<th>This Webinar</th>
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<tr>
<td>Presentation of financial liabilities applying the Board’s preferred approach</td>
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What is the problem?

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 pay cash. 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.
The scope of separate presentation

- Financial liabilities that contain no obligation for an amount independent of the entity’s available economic resources
- Derivatives classified as financial assets/liabilities that have a net amount unaffected by any “independent variables”
- Particular foreign currency derivative assets/liabilities that are “partly independent”
Separate presentation in statement of financial performance

Contains an obligation for an amount independent of the entity’s available economic resources?*

**YES**

Income statement (Profit or Loss)

<table>
<thead>
<tr>
<th>Income and expenses from financial liabilities that have the amount independent of the entity’s available economic resources</th>
<th>X/(X)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit for the period</td>
<td>XXX</td>
</tr>
</tbody>
</table>

**NO**

Statement of other comprehensive income

<table>
<thead>
<tr>
<th>Income and expenses from financial liabilities and derivative assets/liabilities that the amount NOT independent of the entity’s available economic resources</th>
<th>X/(X)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other comprehensive income</td>
<td>XXX</td>
</tr>
</tbody>
</table>

*For derivatives, is the net amount of the derivative affected by any independent variable? For partly independent own equity derivatives, consider the specific criteria (see slide 9).
Consider an example:
Written call option on own shares

- 5 own shares
- Receive
- Deliver
- Net-cash settled
- CU100

• Classified as a derivative liability because of an obligation to deliver cash
• But the net amount of the written call option is unaffected by any independent variable, i.e., its income and expenses are driven by changes in the entity’s available economic resources.

Present total income and expenses in respect of this derivative in other comprehensive income
Consider an example: Written call option on own shares (gross physically settled)

- Classified as a derivative liability because the net amount of the call option is affected by an independent variable (FX rate)
- But its income and expenses would include the effect of changes in the entity’s available economic resources

Assess whether the derivative meets specified criteria (see slide 10)

Present total income and expenses in respect of this derivative in other comprehensive income
The criteria-based approach

Criteria-based approach—apply separate presentation to income and expenses in respect of a financial instrument if the following applies:

<table>
<thead>
<tr>
<th>Type of Financial Instrument</th>
<th>Criteria</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-derivative financial liabilities</td>
<td>No contractual obligation for an amount independent of the entity’s available economic resources</td>
</tr>
<tr>
<td>Own equity derivatives</td>
<td>No variable independent of the entity’s available economic resources affects the net amount</td>
</tr>
</tbody>
</table>
| Foreign currency derivatives on own equity | Meets all of the following criteria:  
  - the only independent variable affecting the net amount is a currency other than the entity’s functional currency.  
  - the foreign currency (FX) exposure is not leveraged.  
  - the FX exposure does not contain an option feature.  
  - The FX denomination is imposed by an external factor. |
Written call option on own shares (gross physically settled)

Assume that:
- Total income on the call option for the period represents a fair value gain of CU10
- Out of CU10, CU3 is attributed to the effect of the independent variable (foreign currency variable)
- the call option meets all the specific criteria (see slide 10)

The Board’s preferred option

Criteria-based approach

Disaggregation approach

Income statement

<table>
<thead>
<tr>
<th></th>
<th>Criteria-based approach</th>
<th>Disaggregation approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value gain</td>
<td>10</td>
<td>3</td>
</tr>
<tr>
<td>“independent” portion</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Profit</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Other comprehensive income</td>
<td>XXX</td>
<td>XXX</td>
</tr>
</tbody>
</table>

Statement of OCI

<table>
<thead>
<tr>
<th></th>
<th>Criteria-based approach</th>
<th>Disaggregation approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value gain</td>
<td>10</td>
<td>7</td>
</tr>
<tr>
<td>“dependent” portion</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other comprehensive income</td>
<td>XXX</td>
<td>XXX</td>
</tr>
</tbody>
</table>
What if embedded derivatives are not separated?

A. Separate presentation does not apply to the foreign currency convertible bond as the bond as a whole includes an obligation for an amount independent of the entity’s available economic resources.

Apply separate presentation only to embedded derivatives that are separated and hybrid instrument that contain no obligation for an amount independent of the entity’s available economic resources.

B. Separate presentation applies to the embedded written call option subject to specific criteria (see slide 9) even though the entity would have elected to measure the foreign currency convertible bond as a whole at fair value through profit or loss.

Apply separate presentation to all embedded derivatives regardless of whether the FVO option is applied or not.

No preliminary view reached.
Use separate line items in the statement of financial position, for example

<table>
<thead>
<tr>
<th>Statement of financial position</th>
</tr>
</thead>
<tbody>
<tr>
<td>Derivative financial liabilities XXX</td>
</tr>
<tr>
<td>Non-derivative financial liabilities</td>
</tr>
<tr>
<td>economic resources XXX</td>
</tr>
<tr>
<td>not independent of the entity’s available economic resources XXX</td>
</tr>
<tr>
<td>Non-derivative financial liabilities</td>
</tr>
<tr>
<td>independent of the entity’s available economic resources XXX</td>
</tr>
<tr>
<td>not independent of the entity’s available economic resources XXX</td>
</tr>
</tbody>
</table>

Enable users of financial statements distinguish financial instruments with different return characteristics.

Enable users of financial statements distinguish financial instruments with different return characteristics.
Summary of preliminary views

The objective of separate presentation is to facilitate assessments of:

- Balance sheet solvency and returns
- Financial position
  - separate line item in the statement of financial position

For partly independent derivatives:

- Criteria-based approach
- Disaggregation approach
  - OR
  - OCI
    - OR
    - Separate line item within profit or loss
      - OR
      - No recycling
        - OR
        - With recycling

Board's preliminary views:

- Alternative discussed

Funding liquidity and cash flows

Financial position

Given existing disclosure requirements, no further requirements proposed

Note: For hybrid instruments that are measured as a whole under the Fair Value Option, no preliminary view was reached as to whether the separate presentation requirements should be applied to all embedded derivatives or separated embedded derivatives only (see slide 11).
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