Financial Instruments with Characteristics of Equity

Agenda ref: WSS8

Amaro Gomes, Board Member, IASB
Kumar Dasgupta, Technical Director, IASB
Uni Choi, Technical Manager, IASB
Angie Ah Kun, Technical Manager, IASB

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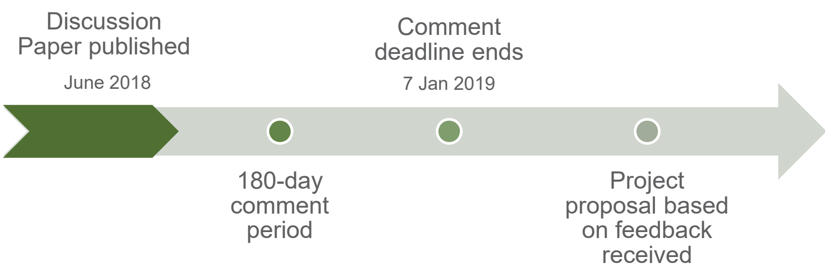
About the project

- 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

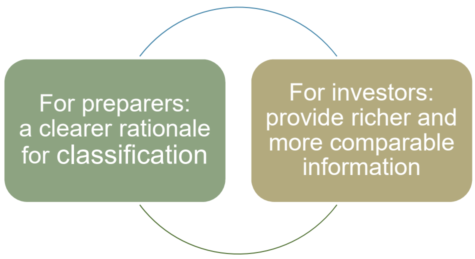
- Classification of financial instruments as financial liabilities or equity instruments
  - issuer perspective

Not in scope

- Recognition and measurement requirements in IFRS 9
- Reconsidering disclosure requirements for financial assets and liabilities in 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:



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

Section 1
Objective, scope and challenges

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
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	

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Question 1

Do you agree that challenges that arise when applying IAS 32 are important to users of financial statements and are pervasive enough to require standard-setting activity?

A. Agree
B. Disagree
C. Undecided

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Section 2
The Board's preferred approach

Section 3
Classification of non-derivative financial instruments

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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

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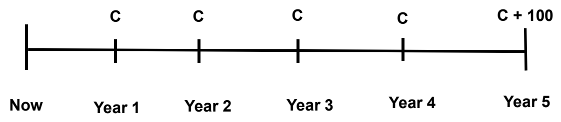
Example 1

Receive CU100 today and pay coupon for 5 years and repay the principal amount of CU100 at the end of Year 5.

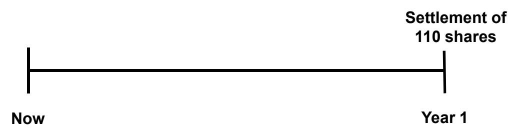


Should it be classified as liability or equity?		
Timing Feature	Any obligation to transfer cash before liquidation?	✓
Amount Feature	Return on instrument independent?	✓

Classified as a financial liability

Example 2

Receive CU100 today and agree to issue 110 own shares in 1 year to settle the amount.

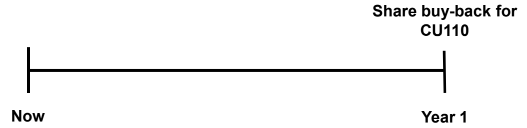


Should it be classified as liability or equity?		
Timing Feature	Any obligation to transfer cash before liquidation?	✗
Amount Feature	Return on instrument independent?	✗

Classified as equity

Example 3

Sell 1 share for CU100 today and agree to buyback the share in 1 year for CU110.



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

Classified as a financial liability

Example 4

Sell 1 share for CU100 today and agree to buyback the share in 1 year at its Fair Value.

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

Classified as a financial liability

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**

Question 2

The Board's preferred approach classifies a non-derivative financial instrument as a financial liability if it contains the timing and/or the amount feature of a financial liability (see slide 15).

Do you agree that classification should be based on both these features?

A. Agree
B. Disagree, the classification should only be based on the timing feature
C. Disagree, the classification should only be based on the amount feature
D. Disagree, the classification should be based on some other feature(s)

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

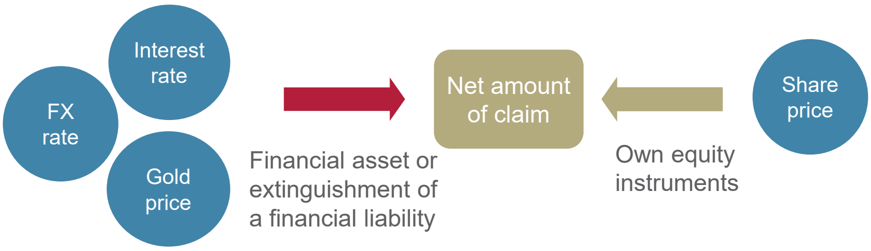
Classification principle that applies consistently to derivatives in their entirety

- 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

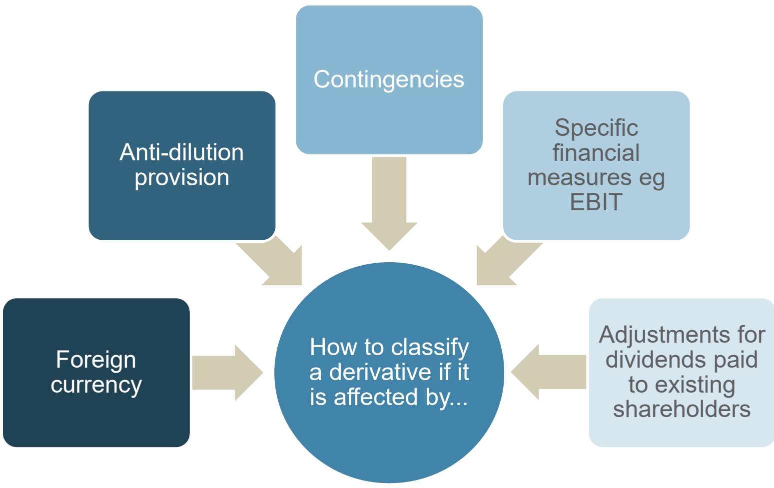
19

- 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

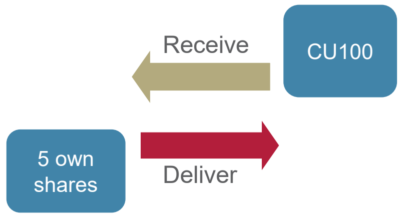
20



Example 5

Written call option

Written call option to sell 5 own shares for CU100 – gross physically settled (ie receive CU100 and deliver 5 own shares)



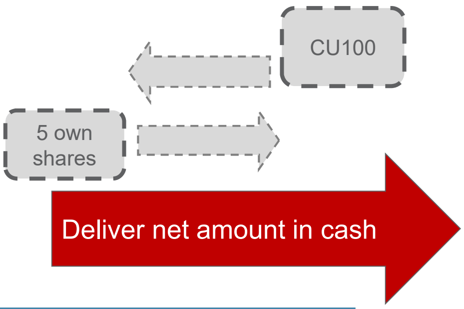
Would it be classified as a derivative liability or equity?		
Timing Feature	Net amount creates an obligation to transfer cash?	✗
Amount Feature	Net amount affected by any variable other than own share price?	✗

Classified as equity

Example 6

Written call option

Written call option to sell 5 own shares for CU100 – net cash settled.



Would it be classified as a derivative liability or equity?		
Timing Feature	Net amount creates an obligation to transfer cash?	✓
Amount Feature	Net amount affected by any variable other than own share price?	✗

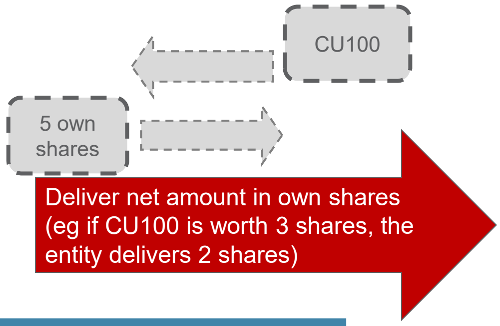
Classified as a financial liability

Example 7

23

Written call option

Written call option to sell 5 own shares for CU100 – net share settled.



Would it be classified as a derivative liability or equity?		
Timing Feature	Net amount creates an obligation to transfer cash?	✗
Amount Feature	Net amount affected by any variable other than own share price?	✗

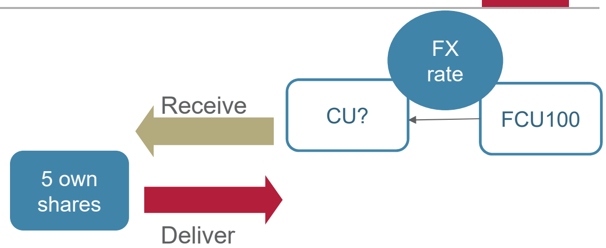
Classified as equity

Example 8

24

Written call option

Written call option to sell 5 shares for 100 foreign currency units (FCU) – gross physically settled.



Would it be classified as a derivative liability or equity?		
Timing Feature	Net amount creates an obligation to transfer cash?	✗
Amount Feature	Net amount affected by any variable other than own share price?	✓

Classified as a financial liability

Question 3

The Board’s preferred approach classifies a derivative on own equity, in its entirety, as a financial asset/liability if it contains either one or both of the features described on slide 19.

Do you agree?

A. Agree
B. Disagree, all derivatives on own equity should be classified as derivative assets/liabilities
C. Disagree, all derivatives on own equity should be broken down into smaller components (e.g. equity component and non-equity component) for classification purposes
D. Disagree for any other reasons

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Section 5
Compound instruments and redemption obligation arrangements

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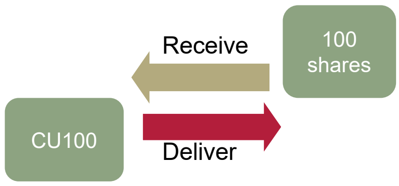
Derivatives that may require extinguishment of own equity instruments

27

- For example, consider a forward contract to purchase 100 own shares in one year's time for a payment of CU100.



- In effect, the derivative has changed the characteristics of the outstanding 100 shares to an unavoidable obligation to pay a fixed amount of cash.
- The obligation to pay CU100 has both the timing and amount features of a financial liability.

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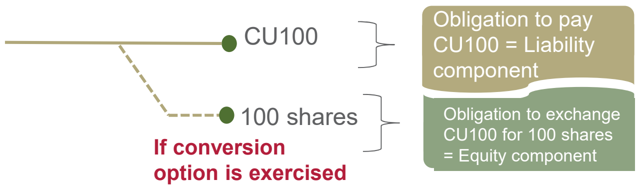
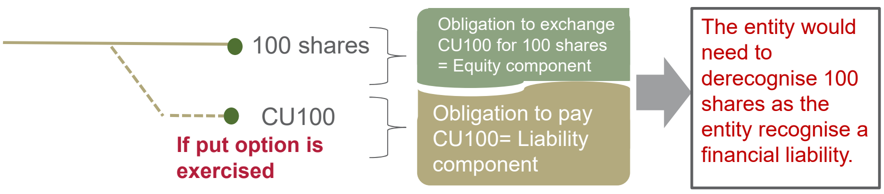
Convertible bonds and written put options

28

Convertible bond —at maturity, the holder has a choice to either receive CU100 in cash or convert the bond to100 shares



A written put option on own shares and own shares — upon exercise of written put the holder has a choice to either keep 100 shares or to exercise the put to receive CU100 in cash and return the shares



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Question 4

Applying the Board's preferred approach, the classification of convertible bonds and written put options on own shares with similar settlement outcomes (for example, see slide 28) would be consistent.

Do you agree that they should be classified consistently?

A. Agree
B. Disagree
C. Undecided

Section 6
Presentation

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 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	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 criteria-based approach

Criteria-based approach–apply separate presentation to income and expenses in respect of a financial instrument if the following applies:	
Non-derivative financial liabilities	**No** contractual obligation for an amount independent of the entity's available economic resources
Own equity derivatives	**No** variable independent of the entity's available economic resources affects the net amount
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.

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Question 5

Do you agree with the Board's preferred approach to presentation of financial liabilities, in particular, the separate presentation of income and expenses from particular financial instruments in OCI, without subsequent recycling?

A. Agree
B. Agree with presentation in OCI, disagree with no reclassification to profit or loss
C. Disagree with presentation in OCI, would prefer a separate line item within profit or loss
D. Disagree with having separate presentation requirements

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Presentation – equity instruments

Start with profit or loss and OCI

Step 1 non-derivative equity instruments — Present the amount of dividends 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 2 derivative equity instruments — Present income and expenses attributable to derivative equity instruments using one of three possible methods

No preliminary view formed

Step 3 ordinary shares — Present the remaining income and expenses attributable to ordinary shares

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Question 6

Do you agree with the Board's preliminary view that it would be useful to users of financial statements to expand the attribution of income and expenses to equity instruments other than ordinary shares?

A. Agree
B. Disagree
C. Undecided

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Section 7
Disclosure

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Disclosures

- The Discussion Paper explores possible requirements to disclose:
  - the priority of claims on liquidation
  - the potential dilution of ordinary shares
  - 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

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Disclosure -
Priority of claims on liquidation

- Currently, IFRS disclosure requirements do not specify any specific disclosures resembling the example below.
- In the DP, the Board proposes that disclosures similar to the table below be presented either on the face of the financial statements, or in the notes.

Order of Priority	As of 1 January 20XX In CU million
Senior Secured Loan	X
Junior Secured Loan	X
Subordinated notes	X
Total Liabilities	**XX**
Non-cumulative preference shares	X
Ordinary shares	X
Total Equity	**XX**
Total Capitalisation	**XXX**

Applies to all financial liabilities as well as equity instruments

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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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Section 8
Contractual terms

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Economic compulsion and indirect obligations

42

- 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.
- 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. Classification would be based on rights and obligations established by a contract, including obligations that are established indirectly through the terms of the contract.
- 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.

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