June 2018

IFRS® Standards
Discussion Paper

Snapshot: *Financial Instruments with Characteristics of Equity*

This Snapshot provides an overview of the Discussion Paper *Financial Instruments with Characteristics of Equity* published by the International Accounting Standards Board (Board).

Project objectives	To improve the information companies provide in their financial statements about financial instruments they have issued, by: • investigating challenges with the classification of financial instruments applying IAS 32 *Financial Instruments: Presentation*; and • considering how to address those challenges through clearer principles for classification and enhanced requirements for presentation and disclosure.
Project stage	The Discussion Paper is seeking comments on: • the financial reporting challenges the Board has identified; • whether the challenges are sufficiently important and pervasive to require standard-setting activity; and • the Board's preferred approach to addressing the challenges.
Next steps	The Board will consider the comments received on this Discussion Paper before deciding whether to develop an Exposure Draft with proposals to amend or replace IAS 32 and/or develop non-mandatory guidance.
Comment deadline	7 January 2019

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Why is the Board undertaking the project?

The Board is seeking to improve the information companies provide in their financial statements about financial instruments they have issued.

When a company issues a financial instrument, the company (issuer) classifies it as either a liability or as equity in its financial statements. This distinction is important because the classification of the instrument affects how the issuer's financial position and performance are depicted. For example, changes in the carrying amount of a financial liability would be recorded in profit or loss whereas changes in equity would not.

IAS 32 sets out how the issuer should classify financial instruments as financial liabilities or equity instruments.

IAS 32 proved robust during the global financial crisis of 2007–8 and it works well for most financial instruments. However, continuing financial innovation means that issuers find it challenging to use IAS 32 to classify some complex financial instruments that combine features of both liabilities and equity. Also, the reasons for particular classification outcomes when applying IAS 32 are not always clearly explained.

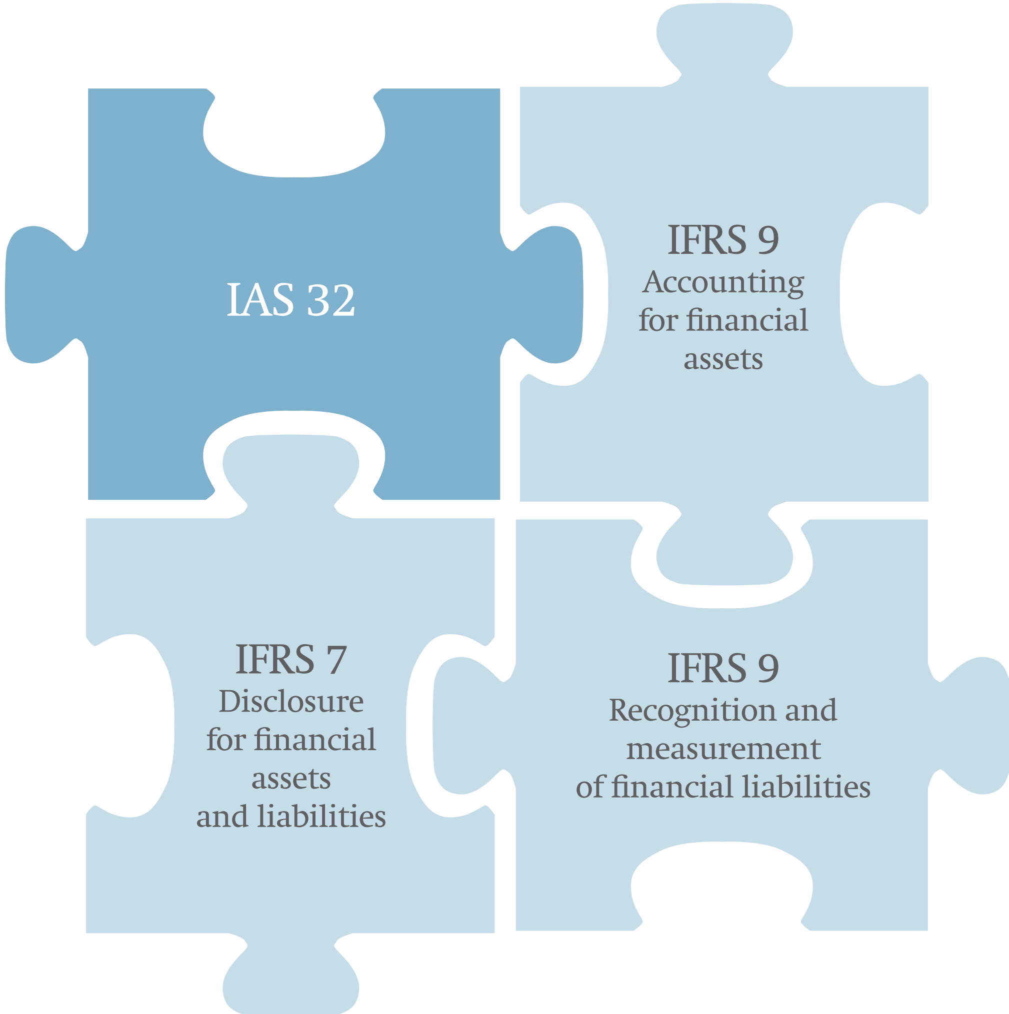
This can result in accounting diversity in practice. Such diversity in turn makes it difficult for investors to assess how these financial instruments affect issuers' financial position and performance. In addition, investors have been calling for more information about equity instruments.

What is the scope of this project?

This project focuses on the classification of financial instruments, from the perspective of the issuer, as financial liabilities or equity instruments.

This project does not address other accounting requirements for financial instruments, such as:

- recognition and measurement requirements in IFRS 9 *Financial Instruments*; or
- disclosure requirements in IFRS 7 *Financial Instruments: Disclosures*.



How is the Board addressing the challenges identified?

IAS 32 works well for most financial instruments, but presents challenges for some complex financial instruments. In addition, the basis for classification is not always clearly explained in IAS 32.

The Board observed that:

- many of challenges in the application of IAS 32 arise because the Standard does not always provide a clear rationale for its requirements; and
- the distinction provided by classifying financial instruments as financial liabilities or equity instruments can provide only a limited amount of information.

To respond to the challenges identified, the Board has developed an approach that would:

- articulate principles for classifying financial instruments as financial liabilities or equity instruments with a clear rationale;
- improve the consistency, completeness and clarity of the classification requirements, in particular, for financial instruments that present accounting challenges in practice; and
- improve the information provided through presentation and disclosure about features of financial liabilities and equity instruments not captured by classification alone.

In responding to the challenges, the Board is seeking to limit unnecessary changes to classification outcomes of IAS 32 that are already well understood and considered to provide useful information.

Applying the Board's preferred approach, classification of most types of financial instruments would remain unchanged.

In addition, the Board would carry forward some existing requirements largely unaltered. For example:

- IAS 32 would retain its requirement to account for some puttable instruments as if they were equity instruments;
- the conclusions in IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* would remain unchanged; and
- neither the definition of a financial instrument nor the way in which classification would (or would not) be affected by economic compulsion and laws and regulation would change.

Classification principles —in essence, simple ideas

Articulate the classification principles with a clear rationale

The Board has sought to establish principles that would classify financial instruments by reference to the presence or absence of particular features. To establish those principles, the Board has identified two features that users of financial statements regard as important. A financial liability would have either one or both of the features described in the table.

Features of a financial liability	The issuer can be required to pay cash or to hand over another financial asset before liquidation.	The issuer has promised a particular return to the holder regardless of the issuer's own performance and share price.
Because ...	This 'timing feature' is relevant for assessments of liquidity and cash flows, even if the issuer has sufficient assets to meet these obligations.	This 'amount feature' is relevant for assessments of solvency and returns, even if the financial instrument does not require transfers of economic resources (for example, if it is a share-settled bond).

The Board's preferred approach

Articulate the classification principles with a clear rationale

The Board developed its preferred approach based on simple ideas.

The Board's preferred approach would classify a financial instrument as a financial liability if the instrument contains:

(a) an unavoidable contractual obligation to transfer cash or other financial assets other than at liquidation (the '**timing**' feature); and/or

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

Financial instruments would be classified as equity instruments if they do not contain either of these two features.

Amount feature / Timing feature	Obligation for an amount independent of the issuer's available economic resources	<u>No</u> obligation for an amount independent of the issuer'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

Addressing challenges in practice

Improve the consistency, completeness and clarity of the classification requirements

In the Board's view, its preferred approach would result in consistent classification of similar contractual rights and obligations, and hence provide comparable information for investors.

Consistent classification outcomes for similar contractual rights and obligations

IAS 32 includes classification requirements for bonds that give the holder an option to convert the bond into a fixed number of equity instruments. The Standard requires them to be treated as compound financial instruments with a liability component and an equity component.

However, IAS 32 does not provide a clear rationale for those requirements. The requirements for compound instruments have worked well for simple convertible bonds but, due to the lack of rationale, have led to challenges for more complex instruments.

For example, IAS 32 provides limited guidance on the accounting within equity for obligations that a company has to extinguish its own equity instruments, for example, when a company has written a put option on its own shares.

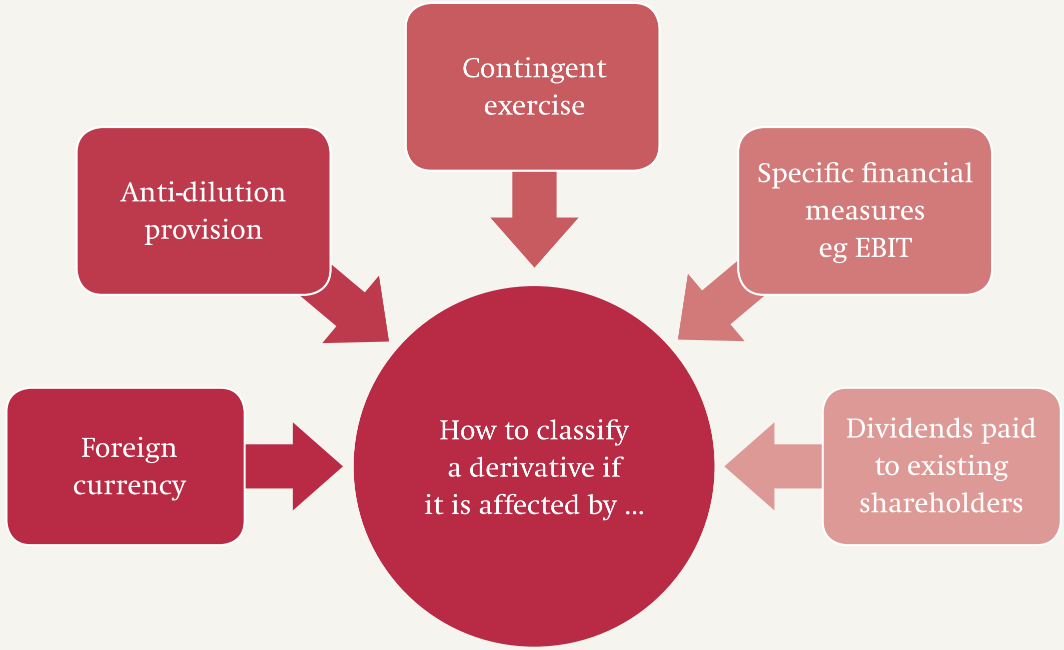
The Board's preferred approach aims to provide clear classification requirements that can be applied consistently between issuers and that will result in consistent classification outcomes for different financial instruments with similar economic effects.

Improve the consistency, completeness and clarity of the classification requirements

Addressing challenges for derivatives on own equity

Issuers of financial instruments have consistently said they face particular challenges in classifying derivatives on their own equity, applying IAS 32. IAS 32 classifies derivatives on own equity using the so-called fixed-for-fixed condition. Although this condition works well for simpler derivatives, it has led to application difficulties for complex ones because IAS 32 does not provide a rationale for this condition.

The Discussion Paper considers how the Board's preferred approach would address these practice challenges. The Discussion Paper considers a number of different variables common in such derivatives and analyses their effect on classification, applying the Board's preferred approach. Essentially, if the settlement value (the net amount) of the derivative on own equity is affected by factors other than the entity's own share price or the time value of money, the derivative would be classified as a derivative financial asset or a derivative financial liability.



Presentation and disclosures

Improve information provided through presentation and disclosure

Binary classification of financial instruments as liabilities or equity is a blunt distinction for a spectrum of instruments. To help distinguish instruments at different points on the spectrum, the Board's preferred approach would also involve enhanced presentation and disclosure requirements.

Presentation

The Board's preferred approach would enhance information provided through presentation on the face of the financial statements, including:

- information about 'the amount feature' of financial liabilities that would be provided through separately presenting financial liabilities with different types of amount features in statements of financial position and financial performance (see page 10); and
- information about equity instruments that would be provided by attributing total income and expense to equity instruments other than ordinary shares (see page 11).

Disclosure

The Board's preferred approach also includes additional information about both financial liabilities and equity instruments that would be provided through disclosure in the notes to the financial statements (see page 12).

Presentation—financial liabilities

Improve information provided through presentation and disclosure

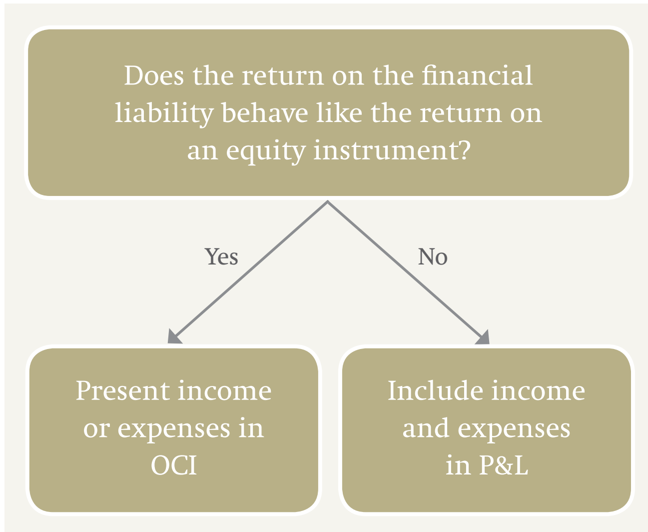
Not all financial liabilities are the same. The Board's preferred approach would distinguish financial liabilities that provide equity-like returns from other financial liabilities.

Applying the Board's preferred approach described on page 6, some financial instruments would be classified as financial liabilities even though the issuer's obligations were dependent on its available economic resources, that is, the instruments provided an equity-like return. For example, a financial liability may include an obligation to transfer cash equal to the fair value of the issuer's ordinary shares.

Accounting requirements for such financial liabilities can lead to the issuer of those financial liabilities recording a loss in respect of the liabilities when the issuer performs well, and recording a gain when it performs poorly. Such accounting outcomes can be regarded as counterintuitive. Therefore, the Discussion Paper suggests a way of distinguishing financial liabilities with equity-like returns from other financial liabilities by:

- presenting these liabilities separately from other financial liabilities as a separate line item in the statement of financial position; and
- presenting separately income or expenses resulting from these liabilities in the statement of financial performance—outside the statement of profit or loss (P&L) in other comprehensive income (OCI).

Separate presentation would extend to some foreign currency derivatives, for example, some warrants in which the exercise price is denominated in foreign currency.



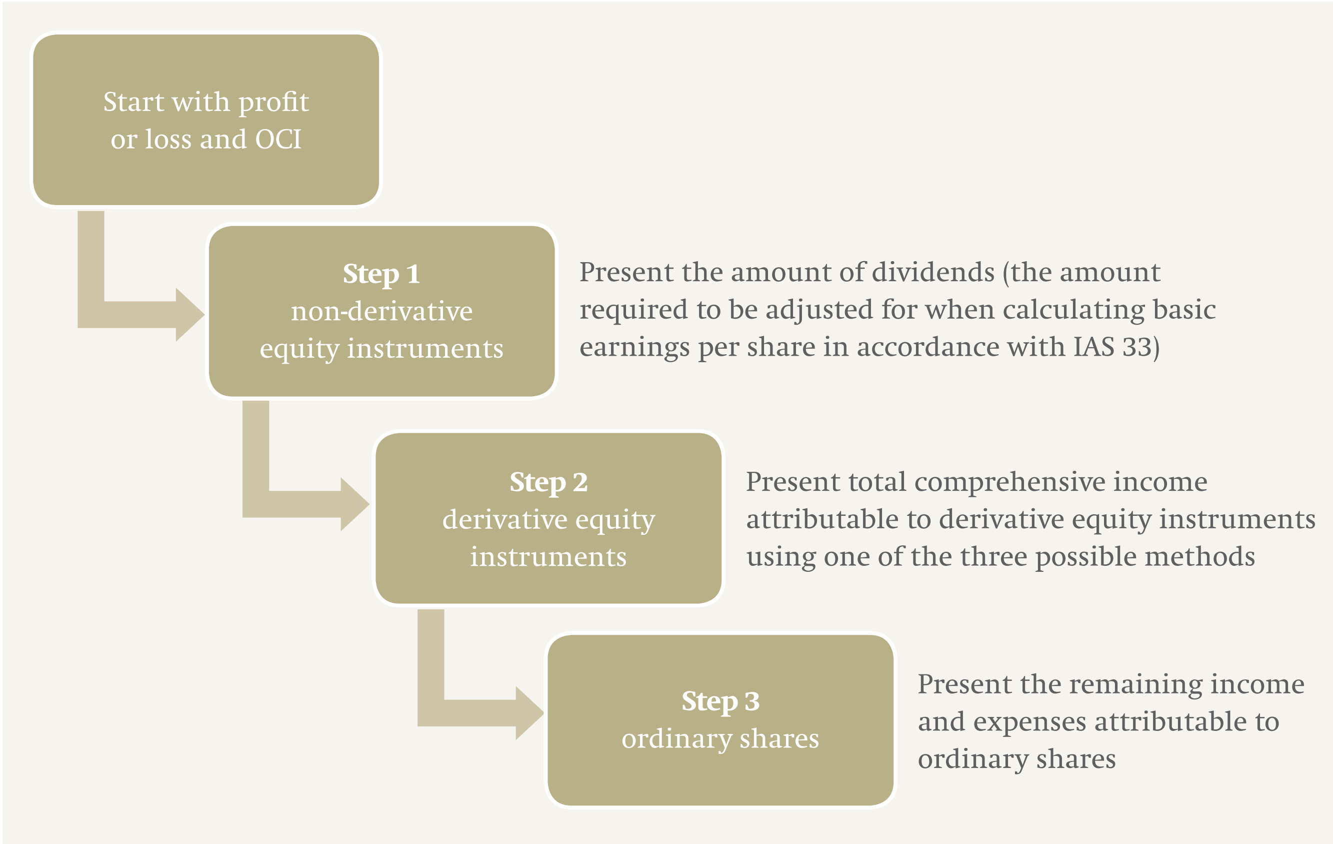
Presentation—equity

Investors have consistently requested more information about equity instruments.

The Board's preferred approach would require companies issuing more than one type of equity instrument to provide information about how returns are distributed among those equity instruments.

Information about how returns are distributed among equity instruments would help investors understand returns on different types of equity instruments and provide potentially more insightful inputs for calculating ratios such as price-to-earnings ratios and price-to-book ratios.

The Discussion Paper explores different methods of attributing total comprehensive income to derivative equity instruments. Feedback is sought on whether the Board should explore requirements for attribution further and if so which method of attribution would provide the most useful information.



Disclosure

Improve information provided through presentation and disclosure

Investors have requested more information to enable them to understand the effects of financial instruments on an issuer's financial position and performance and to understand the rankings of different providers of finance. Currently, IFRS Standards require little information, if any, to be provided about such effects and rankings. In addition, investors have told us that enhanced information about dilution of ordinary shares is needed.

In response to these requests, the Discussion Paper suggests that issuers of financial instruments should be required to disclose:

(a) each class of financial liabilities and equity instruments ranked in order of priority on liquidation (an example is illustrated in the table to the right);

(b) potential dilution of ordinary shares, that is, any actual or potential increase in the number of issued ordinary shares as a result of settling a financial instrument regardless of whether the effect is dilutive or anti-dilutive; and

(c) particular contractual terms of financial liabilities and equity instruments, for example, contractual terms that are relevant to understanding the amount and timing features of a financial instrument.

Financial instruments in the order of priority on liquidation

	As of 1 Jan 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**

Practical issues addressed

Issuers of financial instruments have identified a variety of challenges with applying IAS 32. The Board's preferred approach would address the challenges that preparers have identified.

Challenges	Applying the Board's preferred approach would:
Application of the 'fixed-for-fixed' condition to derivatives on the issuer's own equity	provide a clear principle for classifying derivatives on own equity. Classification would be based on the timing and amount features described on page 6. In particular, the approach would clarify that, for a derivative to be classified as equity, the net amount of the derivative must not be affected by any variables that are independent of the issuer's available economic resources. 'Fixed-for-fixed' derivatives on own equity would still be classified as equity instruments.
Accounting for put options written on equity instruments including those on non-controlling interests	(a) achieve consistent classification outcomes for arrangements with similar economic effects on the issuer, eg convertible bonds and written put options (as described further on page 7); (b) provide more guidance on accounting within equity, for example, accounting entries to be made on initial recognition and on expiry or on exercise of the put options; and (c) require separate presentation of income and expenses in OCI for liabilities with amounts linked to share price, for example, shares that the entity may be required to redeem or repurchase at fair value.
Accounting for bonds that are contingently convertible to equity	clarify classification of liability and equity components, and clarify how the contingency would (or would not) affect the classification. Consistent with any other derivatives on own equity, the contingent conversion option would be classified as equity only if the net amount of the option is unaffected by any variables that are independent of the issuer's available economic resources.

continued ...

… continued

Challenges	Applying the Board's preferred approach would:
Inconsistency between classification requirements for stand-alone foreign currency share options and the requirements for share options embedded in a foreign currency convertible bond	achieve consistent classification outcomes regardless of whether the derivative is a standalone financial instrument or embedded in another financial instrument. Stand-alone or embedded derivatives on own equity would be classified as derivative assets or liabilities if their net amount is affected by a foreign currency variable. Separate presentation of income or expenses in other comprehensive income may be required.
Classification of callable preference shares with step-up dividend clauses that allow the entity to defer payment indefinitely	require the issuer to classify such instruments as financial liabilities if the amount feature is independent of the entity's available economic resources (eg if the step-up results in the amount due on the instrument on liquidation is equal to those of a cumulative instrument). The classification would be determined without the need to consider the issuer's economic incentives to pay dividends.

Further information

The Discussion Paper includes questions on the topics presented in the Discussion Paper. Respondents are invited to respond to any or all of those questions and to comment on any other matter that the Board should consider before deciding whether to develop an exposure draft with proposals to amend or replace parts of IAS 32 and/or to develop non-mandatory guidance. The feedback received will also be used to inform the Board's other projects. The Board's discussions will take place in public meetings. To access information about those public meetings, to view the Discussion Paper and to submit your comments, please visit www.ifrs.org.

The deadline for comments on the Discussion Paper is 7 January 2019.

To stay up to date with the latest developments and to sign up for email alerts about the project, please visit the project homepage on www.ifrs.org/projects/work-plan/financial-instruments-with-characteristics-of-equity/.

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