Australian Government
Australian Accounting Standards Board

Financial Instruments with Characteristics of Equity

Presented by;

AASB Staff

4 September 2018

Agenda

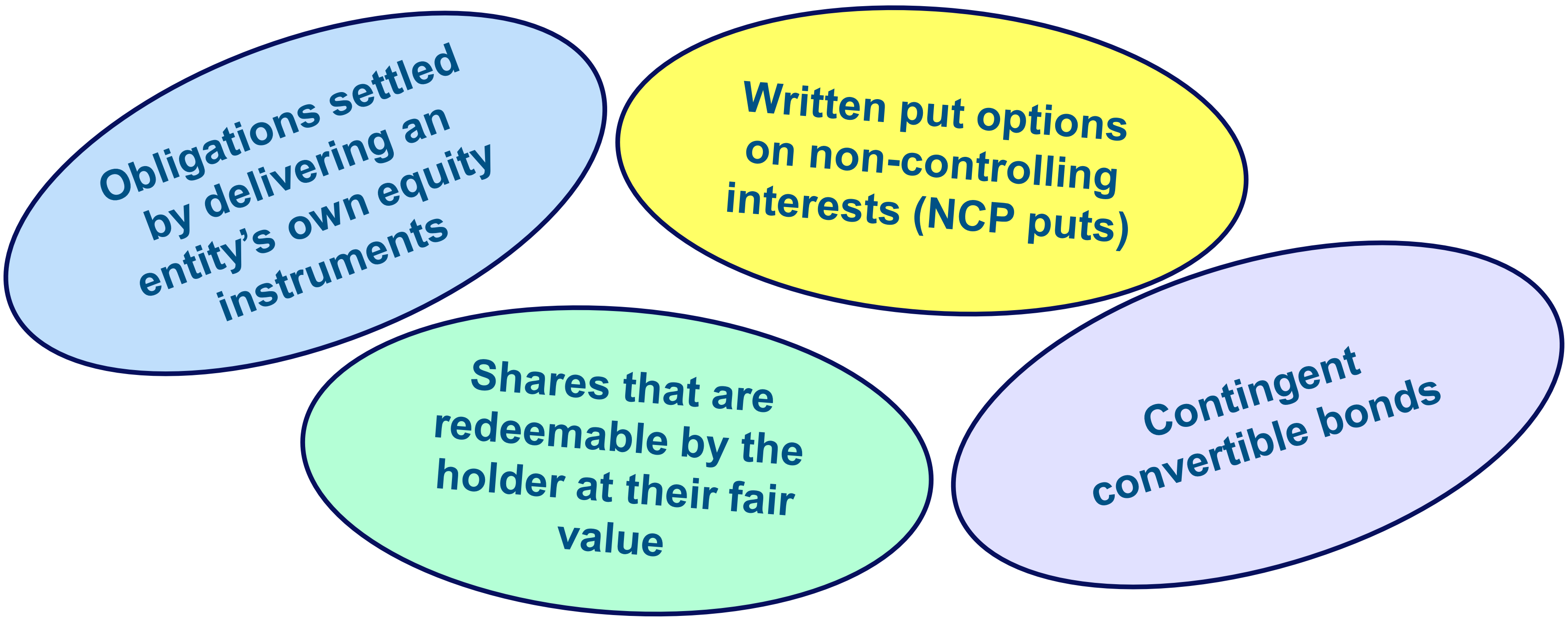
- Objective of the project
- Scope of the project
- Classification of non-derivative financial instruments
- Classification of derivatives financial instruments (including derivatives on own equity)
- Other matters (the ‘puttable exeption’, co-operative and mutual enterprises, the ‘foreign currency rights issue’ exception, written put options on non-controlling interests)
- Presentation
- Disclosures
- Project plan and next steps

Objective of the project

- To address some of the **challenges** arising from the application of IAS 32 *Financial Instruments: Presentation* through clearer principles for classification and enhanced requirements for presentation and disclosure

Challenges

- IAS 32 lacks clear rationale for the requirements in relation to…



Scope of the project

IN SCOPE

Classification of financial instruments as **liabilities** or **equity** from the issuer's perspective

IAS 32 *Financial Instruments: Presentation*

NOT IN SCOPE

Recognition and measurement in IFRS 9 *Financial Instruments*

Disclosures in IFRS 7 *Financial Instruments: Disclosures*

What is the IASB not proposing to change?

- Definition of a financial instrument in IAS 32
- Requirement to separate non-derivative financial instruments that include both a liability and an equity component (i.e. compound instruments) (paragraph 28 of IAS 32)
- Requirement not to consider economic compulsion when classifying financial instruments
- ‘Puttables exception’ in IAS 32
- Conclusion in IFRIC 2 *Members’ Shares in Co-operative Entities and Similar Instruments*

IASB's preferred classification of non-derivative financial liabilities

A claim is a **financial liability** if it contains an **unavoidable obligation**:

a) To transfer economic resources at a **specified time** other than at liquidation;

Timing feature → Funding liquidity and cash flows

and/or

b) For an amount **independent** of the entity's available economic resources.

Amount feature → Balance sheet solvency & returns

Some inconsistencies with the Conceptual Framework definition of liabilities (refer to slide 8)

IASB’s preferred classification of equity

An equity instrument is any contract that evidences a **residual interest** in the assets of the entity, after deducting all of its liabilities

Consistent with the *Conceptual Framework* definition of equity!

Differences with IASB's revised *Conceptual Framework*

- Different classification outcomes arise when applying IASB's preferred approach and the principles in the *Conceptual Framework* (CF)

  Examples:

  ✓ Irredeemable cumulative preference shares

  ✓ Obligations to deliver a variable number of shares equal to a fixed amount of cash

- The conflict between the CF and IASB's preferred approach may lead to contracts that are economically similar in terms of values and risks being classified differently

Question: Do you think the liability classification in IAS 32 and CF should be changed to align to the IASB's preferred approach in the Discussion Paper?

Non-derivative financial instruments

Amount feature / Timing feature	**Obligation for an amount independent of the entity's available economic resources** (such as fixed amounts, based on interest rates or other financial variables)	**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 economic resources at a specified time other than at liquidation (such as scheduled cash payments)	**Liability** (e.g. simple bonds, loans)	**Liability** (e.g. shares redeemable at fair value)
No obligation to transfer economic resources at a specified time other than at liquidation	**Liability** (e.g. share-settled bonds, cumulative preference shares)	**Equity** (e.g. ordinary shares)

How the IASB's preferred approach helps users

Timing feature helps assess funding liquidity & cash flows

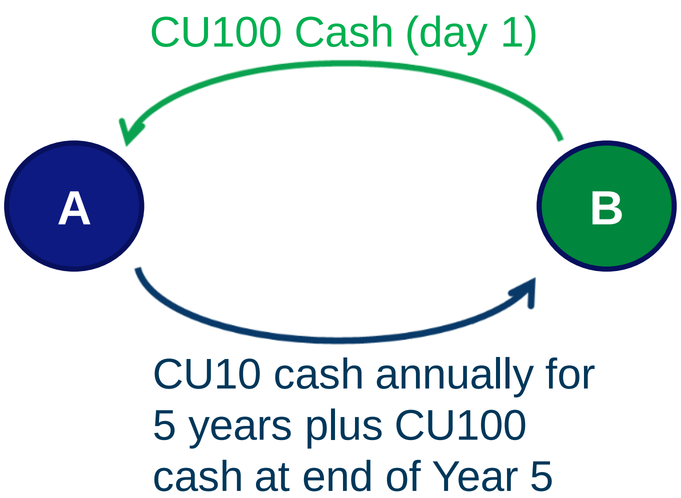
- ✓ whether the entity has **sufficient economic resources** to meet its obligations as and when they fall due
- ✓ **liquidity analysis** (e.g. current ratio and quick ratio)

Amount feature helps assess balance-sheet solvency & 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** (e.g. interest coverage, leverage ratio)

Example 1 – Simple Bond

Entity A issues an instrument to Entity B for CU100 on Day 1. The contract contains an obligation to pay B a coupon of CU10 annually for 5 years and repay the principal amount of CU100 to B at the end of Year 5.



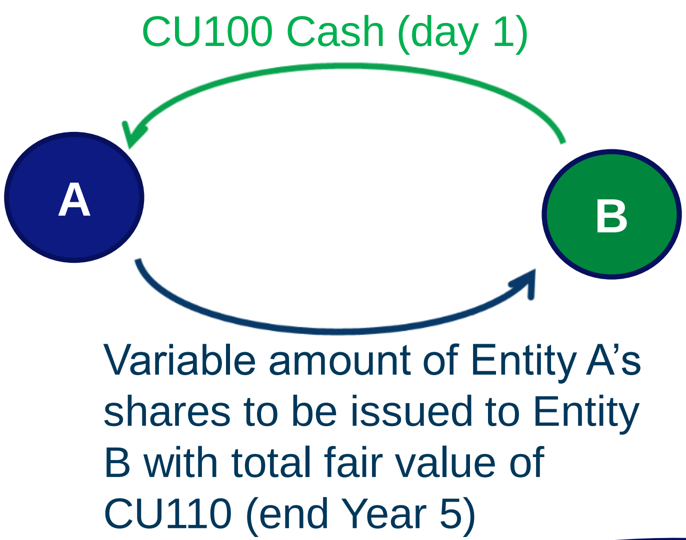
Does Entity A have an unavoidable obligation:	
(a) To transfer economic resources at a **specified time** other than at liquidation	**Yes**
and/or	
(b) For an amount **independent** of the entity's available economic resources?	**Yes**

Classification => Liability

Proposed classification outcome = IAS 32 classification outcome

Example 2 – Share-settled bond

Entity A issues an instrument to Entity B for CU100 on day 1. The contract contains an obligation to issue a variable number of shares to B at the end of year 5 with a total value equal to CU110.



Does Entity A have an unavoidable obligation:	
(a) To transfer economic resources at a **specified time** other than at liquidation	No
and/or	
(b) For an amount **independent** of the entity's available economic resources?	Yes

Classification => Liability

Proposed classification outcome = IAS 32 classification outcome

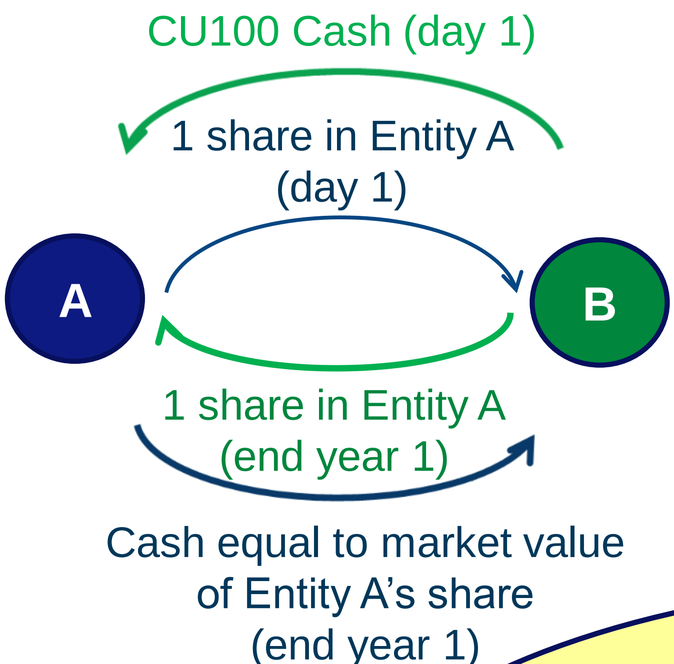
Example 2 – Share-settled bond (Contd.)

- Equity instruments issued by an entity are not economic resources of the entity as per the Conceptual Framework
- There is no transfer of economic benefits and no effect on the entity's assets and liabilities, and no effect on that entity's future cash flows
- But total currency value of the shares is fixed. ie amount feature

Question: Should obligations to deliver own shares be liabilities?

Example 3 – Shares redeemable at fair value

Entity A issues a share in Entity A to Entity B for CU100 on day 1. The contract contains an obligation for Entity A to buy back its own share in one year (in cash) for the market price of the share. Assume the 'puttable exception' in IAS 32 cannot be applied in this example.



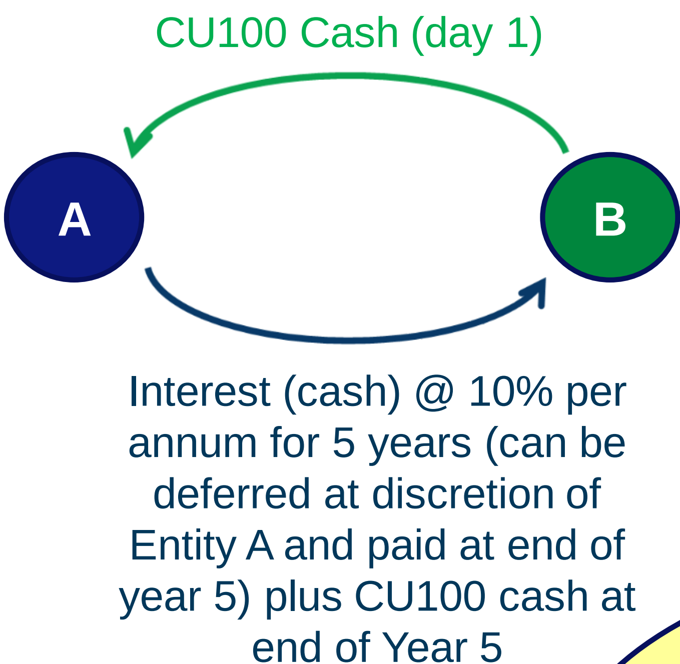
Does Entity A have an unavoidable obligation:	
(a) To transfer economic resources at a **specified time** other than at liquidation	Yes
and/or	
(b) For an amount **independent** of the entity's available economic resources?	No

Classification => Liability

Proposed classification outcome = IAS 32 classification outcome

Example 4 – Cumulative fixed rate redeemable preference shares

Entity A issues an instrument to Entity B for CU100 on Day 1. The contract contains an obligation for Entity A to pay interest at 10% per annum and repay the principal amount of CU100 at the end of year 5. Entity A has the discretion to defer payment of interest until end of year 5, however unpaid interest accumulates until paid.



Does Entity A have an unavoidable obligation:	
(a) To transfer economic resources at a **specified time** other than at liquidation	**Yes**
and/or	
(b) For an amount **independent** of the entity's available economic resources?	**Yes**

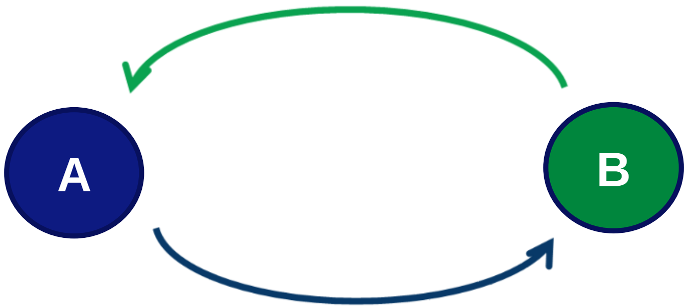
Classification => Liability

Proposed classification outcome = IAS 32 classification outcome

Example 5 – Cumulative fixed rate irredeemable preference shares

Entity A issues an instrument to Entity B for CU100 on day 1. The contract contains an obligation for Entity A to pay interest at 10% per annum 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.

CU100 Cash (day 1)



Interest (cash) @ 10% per annum until liquidation (can be deferred at discretion of Entity A and paid at liquidation) plus CU100 cash at liquidation

Does Entity A have an unavoidable obligation:	
(a) To transfer economic resources at a **specified time** other than at liquidation	**No**
and/or	
(b) For an amount **independent** of the entity's available economic resources?	**Yes**

Classification => Liability

Proposed classification outcome

≠

IAS 32 classification outcome

What are your thoughts?

- **Question:** Have you or your clients issued financial instruments with cumulative features?

- **Question:** Do you think the IASB's preferred classification for non-derivative financial instruments which changes the outcome for these types of transactions captures the substance of these transactions?

Derivatives including derivatives on own equity

Derivatives:

- Contain contractual rights and obligations to exchange underlying financial assets, financial liabilities or equity instruments with another party
- have **‘two legs’** - each leg represents one side of the exchange

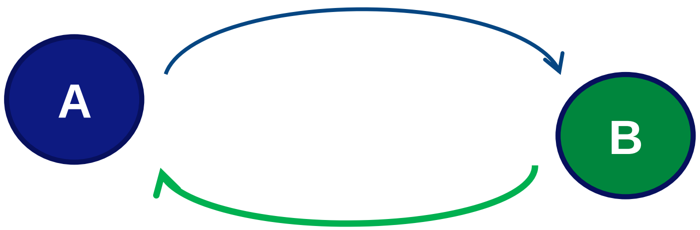
Derivatives on own equity:

- at least one leg of the derivative involves delivery or extinguishment of **an entity’s own equity** instruments; or
- the underlying of the derivative is **an entity’s own equity**

Two types of derivative on own equity

Asset / Equity exchanges

Shares in Entity A

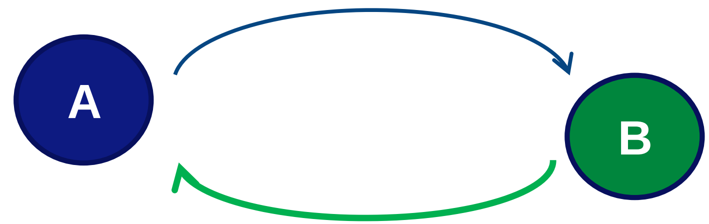


Cash or another financial instrument

- Results in cash (or another financial instrument) and equity in A - neither of which existed until the arrangement settled

Liability / Equity exchanges

Shares in Entity A



Extinguishment of a liability or extinguishment of Shares in Entity A

- Results in extinguishment a liability or shares - both of which were in Entity A's Balance Sheet until the arrangement settled.

More about derivatives on own equity

- Derivatives on own equity might be **settled** in various ways:
  - **gross physically settled** - settled by exchanging the underlying financial instruments;
  - **net-cash settled** - settled net in cash;
  - **Net-share settled** – settled net in equity instruments

- Derivatives on own equity can be:
  - unconditional (e.g. forward contracts);
  - conditional at the option of the holder (e.g. written options);
  - conditional at the option of the issuer (e.g. purchased options); and
  - contingent on some other event beyond the control of both the issuer and the holder.

IASB's preferred classification of derivatives on own equity

1. Classify derivatives on own equity **in their entirety**; and
2. Classify derivatives on own equity as equity instruments, financial assets or financial liabilities

Consistent with existing approach in IAS 32 and approach to accounting for derivatives in IFRS 9

A derivative on own equity is a **financial asset** or a **financial liability** if:

a) It is **net-cash settled**;

Timing feature → Funding liquidity and cash flows

and/or

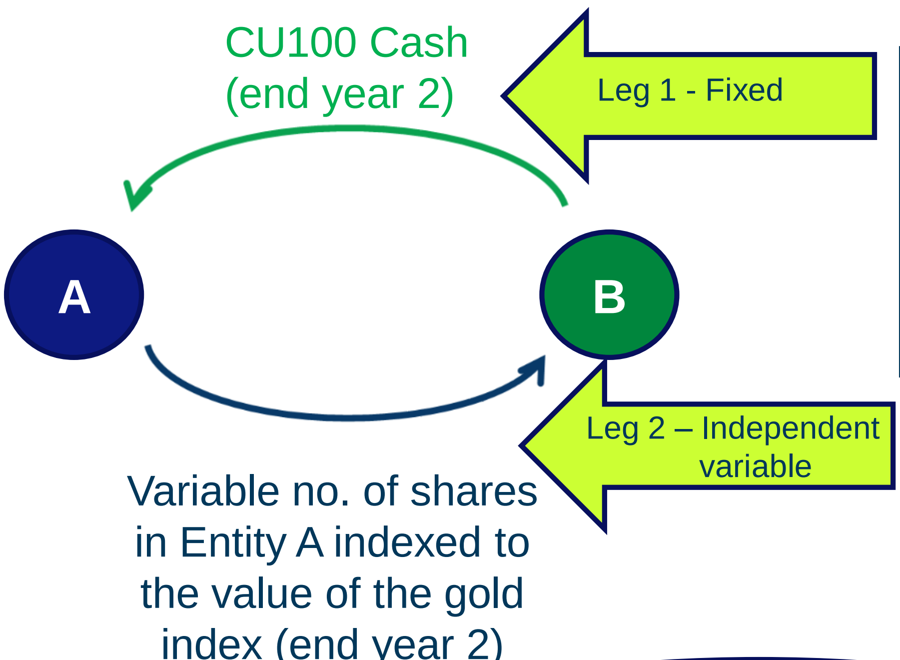
b) The amount of the derivative is affected by a **variable independent** of the entity's available economic resources.

Amount feature → Balance sheet solvency & returns

Otherwise it is an **equity instrument**

Example 6 – Forward contract – independent variable

Entity A enters into a contract with Entity B such that Entity A will receive CU100 (Entity A's functional currency) at the end of Year 2 in exchange for a variable number of its ordinary shares indexed to the value of the gold index.



(a) Is the transaction net-cash settled?	**No**
and/or	
(b) Is the amount of the derivative affected by a variable independent of the entity's available economic resources.	**Yes**

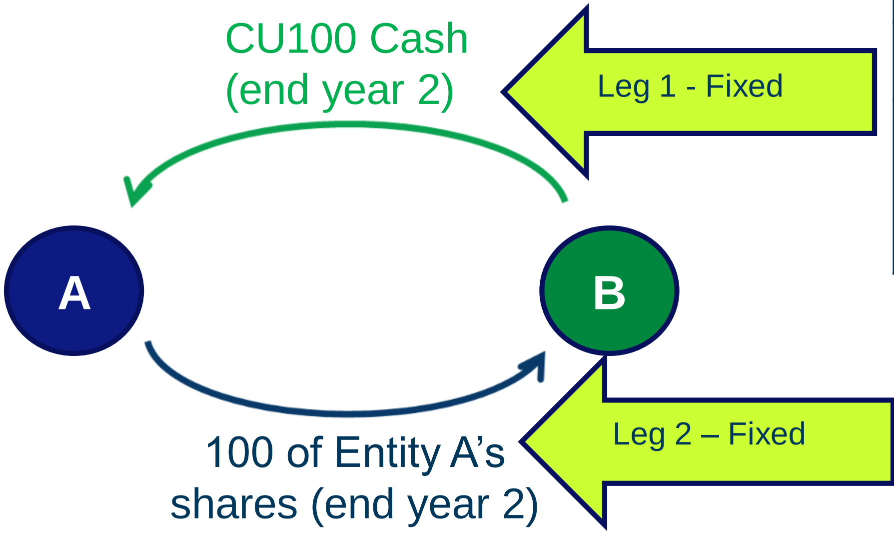
Classification => Asset or liability

Proposed classification outcome = IAS 32 classification outcome

If the above transaction was net-share settled or net-cash settled the same classification outcome would result because of the independent variable

Example 7 – Forward contract – no independent variable

Entity A enters into a contract with Entity B such that Entity A will receive CU100 (Entity A's functional currency) at the end of Year 2 in exchange for 100 of Entity A's shares.



(a) Is the transaction net-cash settled?	**No**
and/or	
(b) Is the amount of the derivative affected by a variable independent of the entity's available economic resources.	**No**

Classification => Equity

Proposed classification outcome for gross physically settled = IAS 32 classification outcome

If the above transaction was net-share settled it would result in the same classification outcome (i.e. Equity)

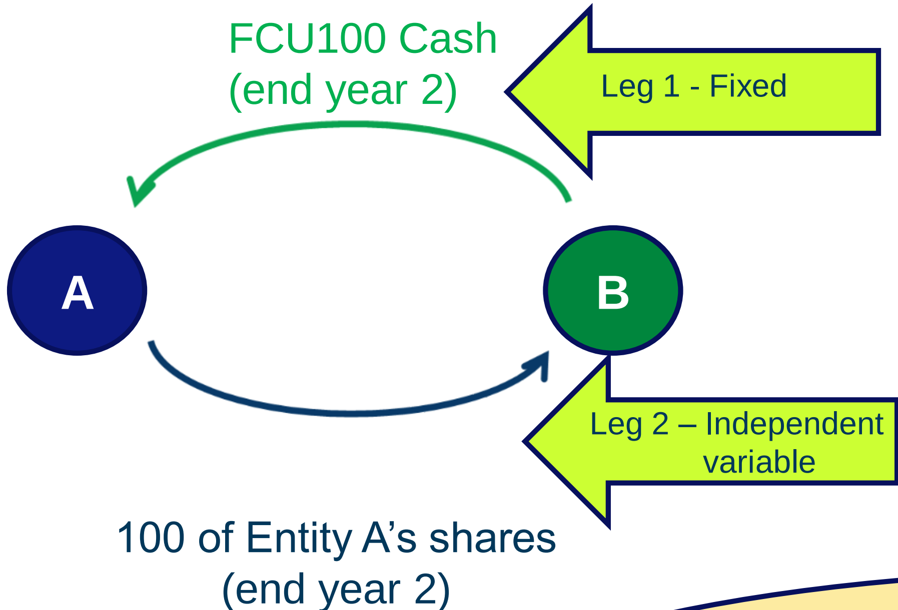
The net-share settled outcome under the IASB's preferred approach is different to the IAS 32 classification outcome

If the above transaction was net-cash settled it would result in a financial asset or liability outcome (because (a) is satisfied)

The net-cash settled outcome under the IASB's preferred approach = IAS 32 classification outcome

Example 9 – Forward contract – foreign currency

Entity A enters into a contract with Entity B such that Entity A will receive FCU100 (Foreign currency) at the end of Year 2 in exchange for 100 of Entity A's shares.



(a) Is the transaction net-cash settled?	**No**
and/or	
(b) Is the amount of the derivative affected by a variable independent of the entity's available economic resources.	**Yes**

Classification => Asset or liability

Proposed classification outcome is the same under IAS 32 unless it meets the foreign currency rights issue exception, in which case it is classified as equity classification outcome

Other matters - the ‘puttable exception’

What is a puttable instrument?

- A financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset or is automatically put back to the issuer on occurrence of an uncertain future event or the death or retirement of the instrument holder

What is the ‘puttable exception’?

- IAS 32 classifies obligations with particular features to transfer economic resources as equity, even though the instruments meet the definition of a financial liability (IAS 32 paragraph 16A – 16D).
- For example when it entitles the holder to a pro rata share of the entity’s net assets in the event of liquidation

What does the IASB proposing?

- The ‘puttable exception’ is retained under the IASB’s preferred approach

Question: Do you agree with retaining the ‘puttable exception’?

Other matters - Co-operative and Mutual Enterprises

What are Co-operative and Mutual Enterprises (CMEs)?

- Entities that seek to provide goods and services in a commercial manner to the benefit of their members and the community in general.
- Members' shares in CMEs are issued when the member joins and are redeemed when they leave (this feature could lead to those shares being classified as liabilities).
- IFRIC 2 / AASB Interpretation 2 provides extensive guidance on classifying members' shares of CMEs

What is the impact of the IASB's preferred approach for CMEs?

- Shares issued by CMEs are still classified as liability in certain instances

Question: Do you know why some CMEs are unable to apply the 'puttable exception'?

Other matters – the 'foreign currency rights issue' exception

What is the foreign currency rights issue exception?

- IAS 32 classifies rights, options, or warrants to issue a fixed number of an entity's own equity instruments in exchange for a fixed amount of **any currency** as **equity instruments**, if, and only if, the entity offers those instruments pro rata to all of its existing owners of the same class of its own non-derivative equity instruments

What is the IASB preferred approach?

- As worked through in Example 9, under the IASB's preferred approach all derivatives to deliver a fixed number of an entity's own ordinary shares for a fixed amount of foreign currency would be classified as **financial assets** or **financial liabilities**.

What are some of the concerns with what the IASB's preferred approach?

- The substance of these transactions may not be appropriately being reflected in the accounting outcome;
- Many Australian entities issue these instruments to meet regulatory requirements and/or access global markets

Question: What is your view about the IASB removing foreign currency rights issue exception in IAS 32 (how will it impact you and/or your clients)?

What are written put options on non-controlling interests (NCI puts)?

- Instruments that require an entity to repurchase the non-controlling interest shares in a subsidiary in exchange for an amount of cash equal to their fair value, at the option of the holder of the NCI put

What the IASB is proposing for NCI puts?

- Consistent classification of rights and obligations regardless of structure
- For NCI puts, this means:
  - ✓ Recognise a liability for the present value of the redemption amount
  - ✓ Derecognise the underlying NCI shares
  - ✓ Classify the remaining rights and obligations using derivative principles

Question: Do you think the IASB's proposals for NCI puts would help address the challenges with the application of IAS 32?

Presentation – Financial Liabilities

Does the return on the financial liability behave like the return on an equity instrument (i.e. the amount is not ‘independent’)?

YES

Statement of other comprehensive income	
Income and expenses from financial liabilities that have equity-like return	xx
Total comprehensive income	xx

NO

Profit or Loss	
Income and expenses from financial liabilities that have debt-like return	xx
Profit	xx

Presentation – Equity instruments

Step 1: Start with profit or loss and OCI

Step 2: Non derivative equity instruments

Present the amount of dividends (the amount required to be adjusted for when calculating basic EPS in accordance with IAS 33

Step 3: Derivative equity instruments

Present income and expenses attributable to derivative equity instruments using **one of three possible methods** (see next slide)

Step 4: Ordinary Shares

Present the remaining income and expenses attributable to ordinary shares (see next slide)

Presentation of equity instruments (continued)

Step 3 Method 1: Full fair value approach	**Step 3 Method 2: Average-of-period approach**	**Step 3 Method 3: End-of-period approach**	**Step 4 Disclosure only**
Attribute total comprehensive income to derivative equity instruments and ordinary shares based on **changes in their fair value.**	Use the **average-of-period fair value ratio** to apportion the entity's total comprehensive income for the period between derivative equity instruments and ordinary shares	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 fair value ratio.	Disclose full fair value of all its equity instruments other than ordinary shares This is similar to extending disclosure requirements related to the fair value of financial liabilities in IFRS 7 to equity instruments

Question: Which of the above proposed methods would you prefer?

Question: What are the cost and benefits of applying the above?

Disclosures

- The priority of claims on liquidation
- The potential dilution of ordinary shares
- Terms and conditions that are relevant to understand the timing or the amount features of the instrument

Order of priority	As at 1 Jan 20xx
Senior secured loan	xx
Junior secured loan	xx
Subordinated notes	xx
Total liabilities	**xxx**
Non-cumulative preference shares	xx
Ordinary shares	xx
Total equity	**xxx**
Total capitalisation	**xxxx**

Project plan and next steps

Key dates	Major project milestones	Staff comment
20 August	Conduct education session for Financial Instruments project advisory panel	obtain preliminary views
24 August	Conduct education session for AOSSG financial instruments and liabilities working group	obtain preliminary views
5 September (M167)	Conduct an education session to the Board and present the project plan	obtain preliminary views and consider the project plan
7 September	AOSSG financial instruments and liabilities working group meeting	Obtain more informed views and outreach plans
20 September and Early November	Financial Instruments project advisory panel meetings	obtain comprehensive views
30 September	Conduct education session at the AOSSG interim meeting	obtain preliminary views
4 October	Present at the ASAF meeting	Present preliminary views obtained form Australian constituents and AOSSG region
10-12 October	Conduct Targeted outreach focusing on big4 firms, Banks, large corporates	Staff to conduct more targeted outreach in October

Project plan and next steps (cont...)

Key dates	Major project milestones	Staff comment
Mid October	Draft the AASB submission	Staff to draft the submission based on the feedback received and comments received so far
13 November (M168)	Present the draft submission to the Board	Obtain Board views and comments on draft submission
Mid November	Draft the AOSSG submission	Staff to draft the submission based on the feedback received from AOSSG member countries so far
20 November	AOSSG financial instruments and liabilities working group meetings	Discuss draft submission to IASB
21 November 2018	Present at the AOSSG annual meeting	Discuss draft submission to IASB
26 November 2018	End of comment period for ITC 40	
28 November 2018	Finalise the AOSSG submissions to IASB	Update the AOSSG submission based on feedback received and circulate to member countries for confirmation
28 November – 13 December	Finalise the AASB and AOSSG submissions to IASB	Update the AASB and AOSSG submissions based on comment letters and other feedback received
14 December 2018	Submit the AASB and AOSSG submissions to IASB	Finalise the AASB and AOSSG submissions