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IFRS Developments

IASB issues discussion paper on financial instruments with characteristics of equity

What you need to know

- The IASB is seeking to improve the requirements for classifying financial instruments with characteristics of equity and/or liabilities without significantly altering most existing classification outcomes of IAS 32. It aims to strike a balance between information best provided through classification and information best provided through presentation and disclosure requirements.
- The FICE project affects a broad range of stakeholders, including users, preparers, auditors and regulators of financial statements.
- The FICE project only affects classification of financial instruments as financial liabilities or equity from the issuer's perspective.
- The FICE DP is open for comment until 7 January 2019.

Introduction

On 28 June 2018, the International Accounting Standards Board (IASB) issued a Discussion Paper, *Financial Instruments with Characteristics of Equity* (the FICE DP). In this paper, the IASB has developed an approach that articulates the principles for the classification of financial instruments as either financial liabilities or equity instruments with a clear rationale, but without fundamentally changing the existing classification outcomes of IAS 32 *Financial Instruments: Presentation*. It is designed to improve the consistency, completeness and clarity of the requirements for classification, while also enhancing the information provided through presentation and disclosure about features of financial liabilities and equity instruments that are not captured by classification alone.

The focus of the FICE project is on the classification of financial liabilities and equity instruments from the perspective of the issuer (the entity). The requirements in IFRS 9 *Financial Instruments* for the accounting by the holder of financial assets are therefore outside the scope of FICE project. Furthermore, the recognition and measurement requirements for these instruments remain unaffected and will continue to be covered by IFRS 9.

Classification

The IASB has proposed an approach that would classify a financial instrument as a financial liability if it contains:

- An unavoidable contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation

  And/or

- An unavoidable contractual obligation for an amount independent of the entity's available economic resources

Building a better working world

The first of the two criteria addresses the timing of any obligation to deliver financial resources, while the second addresses the amount.

The amount of an obligation is independent of the entity's available economic resources if changes in the entity's available economic resources do not result in changes in the amount of the claim. The amount of an obligation is also independent of the entity's available economic resources if the amount of the claim is affected by changes in the entity's available economic resources such that it could exceed the available economic resources of the entity.

Conversely, the amount of a claim is dependent on the entity's available economic resources if changes in the entity's available economic resources result in changes in the amount of the claim such that the amount never exceeds the available economic resources of the entity. Examples of amounts that are dependent on the entity's resources include where they are based on the fair value of the entity's equity instruments.

The table below shows how the IASB's proposed approach would classify financial liabilities and equity instruments:

Distinction based on amount feature / Distinction based on timing feature	Obligation for an amount independent of the entity's available economic resources (such as fixed contractual amounts, or an amount based on an interest rate or other financial variable)	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 cash or another financial asset at a specified time other than at liquidation (such as scheduled cash payments)	**Liability** (eg simple bonds)	**Liability** (eg shares redeemable at fair value)
No obligation to transfer cash or another financial asset at a specified time other than at liquidation (such as settlement in an entity's own shares)	**Liability** (eg bonds with an obligation to deliver a variable number of the entity's own shares with a total value equal to a fixed amount of cash)	**Equity** (eg ordinary shares)

Classification of derivatives

The IASB proposes separate classification principles for derivative financial instruments based on the more general principles, because of particular challenges associated with derivatives on own equity. A derivative on own equity would be classified in its entirety; the individual legs of the exchange would not be separately classified. Such a derivative may be classified as an equity instrument, a financial asset or a financial liability. The DP proposes classifying a derivative on own equity as a financial asset or a financial liability if:

- It is net-cash settled (the 'timing' feature)

  And/or

- The 'net amount' of the derivative is affected by a variable that is independent of the entity's available economic resources (the 'amount' feature)

Presentation

The FICE DP sets out a new approach for presenting changes in the carrying values of certain liabilities on the face of the financial statements. Income and expenses, including fair value gains and losses on those liabilities that contain no obligation for an amount that is independent of the entity's available economic resources, would be presented not in profit or loss, but in other comprehensive income (OCI), without recycling. This would include, for example, gains and losses on put options on shares of non-controlling interests.

The DP also proposes that profit or loss, or OCI, should be attributed to an entity's equity instruments. For non-derivative equity instruments, this would follow the principles of IAS 33 *Earnings per share*, but the attribution would be presented on the face of the statement of financial performance. The IASB has not yet formed a view as to how to make this attribution for derivatives classified as equity and the DP explores several methods, including the use of fair value movements.

Disclosure

The IASB also proposes the following improvements to the disclosure requirements for financial liabilities and equity instruments:

- Priority on liquidation
- Potential dilution of ordinary shares
- Contractual terms and conditions

Implications

The IASB expects most of the existing classification outcomes of IAS 32 to remain the same, for example:

- Obligations to transfer cash and obligations to deliver a variable number of the entity's own shares with a total value equal to a fixed amount of currency would continue to be classified as financial liabilities.
- Ordinary shares, many non-cumulative preference shares and simple derivatives on own equity, such as written call options to deliver a fixed number of an entity's own ordinary shares for a fixed amount of cash, would continue to be classified as equity instruments.

Furthermore, the IASB proposes that some of the requirements of IAS 32 should be carried forward largely unaltered. For example:

- Non-derivative financial instruments that include both a liability and an equity component (compound instruments) would continue to be separated
- The exception for instruments puttable at fair value would be retained (even though it is contrary to the principles of the FICE DP)
- The conclusions in IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* would also be carried forward

Nevertheless, for some financial instruments, there would be changes to the classification and/or presentation outcomes compared to applying IAS 32, for example:

- Financial instruments with obligations for fixed cumulative returns, such as cumulative perpetual preference shares, would be classified as financial liabilities. Applying IAS 32, some of these obligations, for which an entity has an unconditional right to defer cash payment indefinitely, are classified as equity instruments.

- Non-cumulative preference shares which pay discretionary dividends with an obligation to pay a fixed amount at liquidation would now be treated as a compound instrument where the liability component is the obligation to pay a fixed amount of cash at liquidation and the equity component reflects the discretionary dividends. The net present value of the liability may be negligible.
- Derivatives to exchange a fixed number of an entity's own ordinary shares for a fixed amount of cash, that are net-settled by delivering the entity's own equity instruments, would be classified as equity instruments. Applying IAS 32, all net-share settled derivative financial instruments are classified as financial assets or financial liabilities.
- Shares redeemable for their fair value (that do not meet the criteria for the IAS 32 puttables exemption) would be recorded as a liability, but with changes in fair value resulting from changes in fair value presented in OCI.
- 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. Applying IAS 32, some of these derivative financial instruments are classified as equity instruments if they meet the foreign currency rights issue exception. The changes in fair value would, however, be presented in OCI.
- Similarly, the change in fair value of a fixed-for-fixed equity conversion option in a foreign currency denominated convertible bond would be presented in OCI, rather than in profit or loss as required by IAS 32.

How we see it

We support the IASB's efforts to strengthen the principles underlying the classification of liability and equity instruments. Constituents now need to test these new principles, to determine if they can be applied successfully to the range of instruments that they have entered into, or are contemplating, including the more innovative products.

Constituents also need to explore closely the profit or loss and OCI attribution proposals for equity instruments – especially derivatives – to help assess whether they can be applied in practice and whether the costs of doing so are commensurate with the likely benefits to users of the financial statements.

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ED None