Financial Instruments with Characteristics of Equity

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DISCLAIMER

OBJECTIVE OF THE PROJECT

The objective of the FICE research project is to investigate potential improvements to the classification of financial liabilities and equity, presentation and disclosures requirements for financial instruments with characteristics of equity in IAS 32 *Financial Instruments: Presentation*.

IAS 32 outlines the accounting requirements for the presentation and classification of financial instruments into financial assets, financial liabilities and equity instruments.

In the past, the **IFRS Interpretations Committee** (“IFRS IC”) received several submissions related to the **application challenges of IAS 32** and in many cases it was unable to reach a conclusion. The IFRS IC referred these issues to the IASB as the challenges identified required discussion of fundamental concepts in IFRS.

The IASB tried to address the **conceptual challenges** related to the distinction between equity and liability within its **Conceptual Framework** project. However, given that the challenges are both practical and conceptual, the IASB decided to address these issues within the research project FICE, where both the conceptual and application issues are addressed together.

The **objective of the FICE research project** is to investigate potential improvements:

- to the **classification of liabilities and equity** in IAS 32, including investigating potential amendments to the definitions of liabilities and equity in the Conceptual Framework; and
- to the **presentation and disclosure requirements** for financial instruments with characteristics of equity, irrespective of whether they are classified as liabilities or equity.

The outcome of this project is likely to be the **publication of a Discussion Paper** that explores the advantages and disadvantages of alternative ways of making the distinction between equity and liability.

Based on the completion of that research, and the responses to that forthcoming Discussion Paper, the IASB will need to decide **whether to add a project to its Standards-level programme to amend IAS 32** and whether any further changes are needed to the **Conceptual Framework**.

POTENTIAL IMPROVEMENTS TO THE CLASSIFICATION CRITERIA

For the forthcoming Discussion Paper, the IASB identified three new possible approaches for the classification of claims: Alpha, Beta and Gamma. The classification criteria focus on the amount of the claim and the timing of settlement.

Approach Alpha: classifies as liabilities obligations to transfer economic resources prior to liquidation. All other claims will be classified as equity.

Approach Beta: classifies as liabilities obligations for an amount independent of the entity's economic resources. All other claims will be classified as equity.

Approach Gamma: classifies as equity claims that require the transfer of economic resources only at liquidation and the amount of economic resources required to be transferred at liquidation is not independent of the entity's economic resources. All other claims will be classified as liabilities.

The IASB's discussions have been mainly focused on the Gamma approach, which is a combination of Alpha and Beta and is considered the most consistent with IAS 32.
Classification principles depend on the definition of:

- *"Economic resources";*
- *"Amount that is independent of the entity's economic resources";*
- *"Residual amount";*
- *Amount that is "solely dependent on the residual amount"; and*
- *"Liquidation"*

Some illustrative examples:

Ordinary share: claim that does not require the transfer of economic resources before liquidation and the amount of economic resources required to be transferred at liquidation is dependent of the entity's economic resources, thus it is equity under the Gamma approach.

Ordinary bond: claim that contains an obligation of the entity to transfer a specified amount of cash at a specified time prior to liquidation, thus it is a liability under the Gamma approach.

Share redeemable at fair value: claim that requires the transfer of economic resources before liquidation – thus, it is a liability under the Gamma approach.

Cumulative preference share: claim that does not require the transfer of economic resources before liquidation but the amount is independent of the entity's economic resources – thus, it is a liability under the Gamma approach.

Non-cumulative preference share: claim that requires the transfer of economic resources only at liquidation and the amount to be transferred is dependent of the entity's economic resources – thus, it is equity under Gamma approach.

POTENTIAL IMPROVEMENTS TO THE CLASSIFICATION CRITERIA

Many of the application challenges identified are related to the classification of derivatives on own equity.

Derivatives on own equity: the IASB discussed the application of the Gamma approach to different types of derivatives, including the unit of account for their accounting, and tentatively decided that entities should classify derivatives on own equity in their entirety (either equity or liability/asset) rather than splitting them into components or classifying all of them as assets or liabilities (i.e. as derivatives at fair value).

Classification of derivatives on own equity: The IASB is expected to retain the fixed-for-fixed condition and the existing redemption obligation requirements. A key point is the notion of solely or partially dependent on the residual amount, particularly when considering the time value of money, currency, dilution, distributions, non-controlling interest and contingencies.

However, the requirements in IAS 32 may need to be updated to reflect the features used under the Gamma approach and this may lead to some classification changes. For example, written call options on own shares that are physically settled in a foreign currency and meet the foreign currency rights issue exception in IAS 32 will be classified as a liabilities under the Gamma approach while these instruments are classified as equity under IAS 32. This would be a strict form of fixed-for-fixed principle.

Share-settled bonds: deliver a variable number of own shares equal to a fixed amount which is independent of the entity's economic resources. Thus *it is a liability.*

Foreign currency denominated written call option: require the sell of a fixed number of own shares in exchange for a fixed amount in a foreign currency. Amount of the claim partly dependents on the residual amount due to the variability in the cash receipt leg, thus *it is a liability.*

Commodity indexed forward contract: receive a variable amount of cash based on some commodity index (1 ounce of gold) against delivering a fixed number of own shares. Amount partly dependents on the residual amount, thus *it is a liability.*

Warrant: receive a fixed amount of cash equal to strike price in exchange for delivering a fixed number of own shares. Derivative for delivery of own equity, physically settled and the amount solely depends on the residual amount. *It is equity*.

Forward to sell own shares (net share settlement): receive variable amount of own shares worth for the forward price and deliver a fixed number of own shares. Claim does not require the transfer of economic resources before liquidation and the amount is dependent of the entity's economic resources, thus *it is equity.*

POTENTIAL IMPROVEMENTS TO PRESENTATION

The creation of subclasses of liabilities and equity and their separate presentation within the statement of financial position represents a significant change to existing requirements in IAS 1 and IAS 32.

Statement of financial position

	20x2	20x1
Property, Plant and Equipment	44 000	44 000
Cash	1 768	1 000
Total Assets	**45 768**	**45 000**
Non-current liabilities		
Ordinary bonds (LNDRA)	9 000	9 000
Cumulative preference shares (LNDRA)	2 060	2 000
Share-settled bonds (LNDRA)	3 000	3 000
Commodity indexed forward contract (LPDRA)	4 050	4 000
Foreign currency denominated written call option (LPDRA)	1 050	1 000
Current liabilities		
Shares redeemable for their fair value (LSDRA)	1 080	1 000
Total Liabilities	**20 240**	**20 000**
Ordinary shareholders equity	15 000	15 000
Retained earnings	3 351	3 000
Senior Class of shareholders equity		
Derivative Senior Class of Equity *(directly measured)*		
. Warrants (fixed-for-fixed)	2 050	2 000
. Forward sell shares (net-share settlement)	2 050	2 000
Non-Derivative Senior Class of Equity *(directly measured)*		
. Non-cumulative preference shares	2 056	2 000
Non-controlling interest	1 021	1 000
Total Equity	**25 528**	**25 000**

Subclasses of liabilities: the IASB discussed three subclasses of liabilities. Liabilities for:

- a specified amount that does not depend on the residual amount (LNDRA) and
- an amount that solely depends on the residual (LSDRA);
- an amount that is neither completely independent nor solely dependent on the residual amount (LPDRA)..

The financial instruments identified in the previous slides are used on the left to assess the presentation impact of the Gamma approach.

Subclasses of equity: the IASB discussed two subclasses of equity that are expected to be presented separately:

- Ordinary Shares and
- Senior Classes of Equity (the later will be directly measured through the attribution of profit or loss).

For example, warrants; forward to sell own shares (net-share settlement); and non-cumulative will be measured directly through the attribution of profit or loss against retained earnings. The creation of subclasses of equity and direct measurement should help users assessing the allocation of residual returns.

POTENTIAL IMPROVEMENTS TO PRESENTATION

Separate presentation would mean an additional category within OCI, expanding the attribution of comprehensive income to senior classes of equity and updating their respective carrying amounts. This would be a significant change to existing requirements

Statement of profit or loss

	20x2	20x1
Sales	10 000	10 000
Cost of sales	(9 000)	(9 000)
Interest on bonds	(233)	(233)
Dividends on cumulative preference shares	(60)	-
Commodity indexed forward contract	(50)	-
Profit for the year	**658**	**768**
Profit for the year attributable to:		
Owners of the company - ordinary shares	462	656
Non-derivative senior class of equity	69	81
Derivative senior class of equity	100	-
Non-controlling interest	26	31
Earnings per share: Basic	0.04	0.06
Earnings per share: Diluted	0.04	0.05

Statement of profit or loss and other comprehensive income

Profit for the year	658	768
Shares redeemable at fair value	(80)	-
Foreign currency denominated written call option	(50)	-
Total other comprehensive income	**528**	**768**
Total comprehensive income	**528**	**768**
Total comprehensive income for the year attributable to:		
Owners of the company - ordinary shares	351	656
Non-Derivative Senior Class of Equity	56	81
Derivative Senior Class of Equity	100	-
Non-controlling interest	21	31

Separate presentation means that:

- Income and expenses that arise from liabilities for a specified amount that is not dependent on the residual would be allocated to profit or loss (e.g. interest and dividends on cumulative preference shares)
- Income and expenses that arise from liabilities for an amount that solely depends on the residual would be allocated to OCI (e.g. shares redeemable at fair value); and
- Income and expenses that arise from liabilities that are neither completely independent nor solely dependent on the residual will be separately presented in OCI if specific criteria is met (e.g. foreign currency denominated written call option and commodity indexed forward contract).

For liabilities that are not solely dependent of the residual amount, the IASB will develop a criteria for separate presentation in OCI, but it is likely to be limited to specific types of derivatives with foreign currency exposure and only under certain circumstances.

The IASB is considering expanding the attribution of comprehensive income to senior classes of equity to help users assess the allocation of returns amongst different classes of equity (including different allocation methods for derivative and non-derivative equity claims).

COMPARING RESULTS

Under IAS 32, financial instruments classified as equity (e.g. conversion option) are not subsequently remeasured.

Statement of financial position

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Property, Plant and Equipment	44 000	44 000
Cash	1 768	1 000
Total Assets	**45 768**	**45 000**
Non-current liabilities		
Ordinary bonds	9 000	9 000
Forward sell shares (net-share settlement)	2 050	2 000
Share-settled bonds	3 000	3 000
Commodity indexed forward contract	4 050	4 000
Current liabilities		
Shares redeemable for their fair value	1 080	1 000
Total Liabilities	**19 180**	**19 000**
Ordinary shareholders equity	15 000	15 000
Retained earnings	3 564	3 000
Cumulative preference shares	2 000	2 000
Foreign currency denominated written call option (rights issue)	1 000	1 000
Warrants (fixed-for-fixed)	2 000	2 000
Non-cumulative preference shares	2 000	2 000
Non-controlling interest	1 024	1 000
Total Equity	**26 588**	**26 000**

Under the Gamma approach, more information about derivatives on own equity is given on the face of the balance sheet, including subsequent remeasurement within equity (e.g. retained earnings).

Statement of financial position

	20x2	20x1
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Total Assets	**45 768**	**45 000**
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Current liabilities		
Shares redeemable for their fair value (LSDRA)	1 080	1 000
Total Liabilities	**20 240**	**20 000**
Ordinary shareholders equity	15 000	15 000
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Senior Class of shareholders equity		
Derivative Senior Class of Equity *(directly measured)*		
. Warrants (fixed-for-fixed)	2 050	2 000
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Non-Derivative Senior Class of Equity *(directly measured)*		
. Non-cumulative preference shares	2 056	2 000
Non-controlling interest	1 021	1 000
Total Equity	**25 528**	**25 000**

However, challenges arise on how and which equity instruments should be remeasured, related costs and complexity and knock-out consequences to the conceptual framework.

COMPARING RESULTS

Under IAS 32, gains and losses that arise from financial instruments classified as liabilities are typically presented in profit or loss.

Statement of profit or loss

	20x2	20x1
Sales	10 000	10 000
Cost of sales	(9 000)	(9 000)
Interest on bonds	(233)	(233)
Shares redeemable at fair value	(80)	-
Forward to sell shares (net-share settlement)	(50)	-
Commodity indexed forward contract	(50)	-
Profit for the year	**588**	**768**
Profit for the year attributable to:		
Owners of the company - ordinary shares	564	737
Non-controlling interest	24	31
Earnings per share: Basic	0.04	0.06
Earnings per share: Diluted	0.04	0.05

Statement of profit or loss and other comprehensive income

	20x2	20x1
Profit for the year	588	768
Total other comprehensive income	**588**	**768**
Total comprehensive income	**588**	**768**
Total comprehensive income for the year attributable to:		
Owners of the company - ordinary shares	565	738
Non-controlling interest	23	30

Under the Gamma approach, these gains and losses are recognised in OCI if linked to the entity's own performance. Also more information about the allocation of comprehensive income to other classes of equity.

Statement of profit or loss

	20x2	20x1
Sales	10 000	10 000
Cost of sales	(9 000)	(9 000)
Interest on bonds	(233)	(233)
Dividends on cumulative preference shares	(60)	-
Commodity indexed forward contract	(50)	-
Profit for the year	**658**	**768**
Profit for the year attributable to:		
Owners of the company - ordinary shares	462	656
Non-derivative senior class of equity	69	81
Derivative senior class of equity	100	-
Non-controlling interest	26	31
Earnings per share: Basic	0.04	0.06
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Statement of profit or loss and other comprehensive income

	20x2	20x1
Profit for the year	658	768
Shares redeemable at fair value	(80)	-
Foreign currency denominated written call option	(50)	-
Total other comprehensive income	**528**	**768**
Total comprehensive income	**528**	**768**
Total comprehensive income for the year attributable to:		
Owners of the company - ordinary shares	351	656
Non-Derivative Senior Class of Equity	56	81
Derivative Senior Class of Equity	100	-
Non-controlling interest	21	31

However, challenges arise on additional guidance related to the use of OCI and allocation process.

POTENTIAL IMPROVEMENTS TO PRESENTATION

The IASB explored alternative attribution methods for derivative equity claims. An example is included below for a physically settled warrant.

Statement of profit or loss

In monetary units	Approach A	Approach B	Approach C	Approach D
Income	15 000	15 000	15 000	15 000
Expenses	(5 000)	(5 000)	(5 000)	(5 000)
Net result	**15 000**	**15 000**	**15 000**	**15 000**
Attributed to:				
Warrants	-	5 000	2 692	957
Ordinary shares	15 000	10 000	12 300	14 043
EPS (Basic)	15	10	12.3	14
Number of ordinary shares	1 000	1 000	1 000	1 000
Warrants: number of shares to be issued	1 000	1 000	1 000	1 000
Approach B				
Changes in fair value of warrants		5 000		
Approach C				
Fair value of ordinary shares at year end			120 000	*92.31%*
Fair value of warrants at year end			10 000	*7.69%*
Carrying amount of net assets at year end			100 000	
Net assets attributable to warrants based on their relative fair value at year end			7 692	
Carrying amount of warrants at beginning of the year			5 000	
Amount attributed to warrants (100 000 x 7.69% - 5 000)			2 692	
Approach D				
Average fair value of ordinary shares over the year				110 000
Average fair value of warrants over the year				7 500
Total				117 500
Weight of warrants				6.38%
Net result at year end				15 000
Amount attributed to warrants (15 000 x 6.38%)				957

Approach A No attribution for derivative equity claims - With Approach A, current requirements would be maintained and information about the effect of derivative equity claims would continue to be given through diluted earnings per share and other disclosures;

Approach B Full fair value approach - the attribution of profit or loss and OCI to derivative equity claims would be based on changes in their fair value;

Approach C Modified fair value approach - The attribution would be based on changes on components of recognised equity that would be calculated based on the relative fair value of derivative equity claims and other classes of equity; and

Approach D: Ordinary share equivalents approach - the attribution would be based on applying the relative average fair values of equity claims to the total profit or loss and OCI of the year.

For non-derivative equity claims other than ordinary shares (such as non-cumulative preference shares), the attribution will be based on the existing requirements for such instruments in IAS 33 *Earnings per Share.*