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This bulletin is issued by the European Financial Reporting Advisory Group (EFRAG). The publication of bulletins is part of EFRAG's strategy to stimulate debate within Europe and clarify the IASB discussions to the presentation and disclosure requirements for financial liabilities and equity instruments. Any views expressed are tentative. EFRAG will develop its final views after considering the feedback received from its constituents.

Due to the nature of the bulletin, EFRAG has not included questions to constituents. However, constituents may provide their comments by 3 December 2018 through EFRAG's website (www.efrag.org) or by post to:

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All comments received will be placed on the public record unless confidentiality is requested.

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### **EXECUTIVE SUMMARY**

- ES1 In June 2018, the IASB issued the Discussion Paper DP/2018/1 *Financial Instruments with Characteristics of Equity* ('the DP') which proposes the creation of subclasses of equity, subclasses of liabilities and specific presentation requirements for them.
- ES2 For **financial liabilities** that provide equity-like returns, the DP proposes:
  - a) In regard to the statement of financial performance, that income or expenses should be presented in other comprehensive income ('OCI') with no recycling; and
  - b) For the statement of financial position, that these liabilities are presented as a separate line item.
- ES3 Other presentation proposals include:
  - a) Attribution of total comprehensive income to **equity instruments** other than ordinary shares, including instruments such as preference shares, warrants and any derivatives of own equity that are classified as equity.
  - b) Updating of the carrying amount of equity instruments other than ordinary shares, based on the attribution developed for the statement of financial performance. For example, the attribution will lead to an update of the carrying amount of preference shares, warrants and equity instruments other than ordinary shares.
- ES4 Finally, the DP suggests additional disclosures on priority on liquidation, potential dilution of ordinary shares and contractual terms and conditions.
- Although the approach presented in the DP would not fundamentally change the classification outcomes from IAS 32 *Financial Instruments Presentation*, the DP's presentation proposals represent a significant change to current presentation requirements in IAS 1 *Presentation of Financial Statements* and current practice.
- ES6 Currently entities are not required to separately present information about different subclasses of liabilities and equity. In addition, the DP's proposals are expected to raise many questions on the use of OCI and whether the update of the carrying amount of subclasses of equity represent the remeasurement of equity. Such significant changes are most likely to affect companies which use complex financial instruments such as derivatives on own shares and puttable instruments to obtain financing.
- ES7 The proposed disclosures, as a whole, represent a significant extension of disclosures on financial instruments on own equity. They would provide a greater level of detail about financial instruments classified as equity, making the level of disclosure more similar to financial instruments that are classified as liabilities.

### **CHAPTER 1: BACKGROUND**

### **PURPOSE OF THIS BULLETIN**

1.1 The DP describes the IASB's preferred approach to the presentation and disclosure of financial liabilities and equity. In order to help constituents to understand the proposed approach and accordingly to help constituents participating in the debate around the DP, EFRAG has issued this bulletin which explains the relevant presentation and disclosure requirements included in the DP.

### WHY THE IASB PUBLISHED A DP

- 1.2 The IASB has considered how to distinguish liabilities and equity as respondents to the IASB's 2015 Agenda Consultation said that the requirements in IAS 32:
  - a) Are, in some cases, complex, poorly understood and difficult to apply;
  - b) Lead to classification outcomes that do not reflect the economic substance of particular financial instruments common in some jurisdictions;
  - c) Have, over the years, been amended in a piecemeal fashion that has raised practical issues, introduced exceptions and resulted in diversity in practice; and
  - d) Are not robust enough to address the increasing complexity and sophistication of some financial instruments being issued
- 1.3 In addition, submissions to the IFRS Interpretations Committee ('IFRS IC') have revealed challenges in distinguishing financial liabilities from equity instruments in IAS 32 for more complex financial instruments. Such challenges include:
  - a) Application of the fixed-for-fixed condition to derivatives on own equity;
  - b) Application of the requirements in IAS 32 to recognise a 'gross' liability for derivatives that include an obligation for the entity to purchase its own ordinary shares, including the repurchase of the non-controlling interest shares in a subsidiary (e.g. put options written on non-controlling interests); and
  - c) Bonds that pay interest at the discretion of the issuer and mandatorily convert to a variable number of the issuer's own shares if the issuer breaches a certain threshold.

- 1.4 The DP states that while the objective of the project is to respond to challenges in distinguishing financial liabilities from equity instruments when applying IAS 32, any potential solution should limit unnecessary changes to classification outcomes that are already well understood. The DP's proposals for distinguishing financial liabilities from equity instruments are explained in the EFRAG bulletin *Demystifying FICE A clearer picture on classification*.
- 1.5 The DP notes that the changes to the classification principles might not be sufficient to resolve all the challenges the IASB has identified. Enhancing presentation and disclosure requirements could, according to the DP, help address some of those challenges. The DP is therefore also providing some views on presentation and disclosures. When assessing how useful the information resulting from the approach described in the DP would be, it would therefore also be relevant to take the information provided by the proposed presentation and disclosures into account.

### SCOPE OF THE DP

1.6 While the application of the approach presented in the DP might change the presentation and disclosures of a financial instrument as a financial asset, financial liability or an equity instrument, the approach will only apply to instruments within the scope of IAS 32 – which would remain unchanged.

## CHAPTER 2: PRESENTATION OF FINANCIAL LIABILITIES

- 2.1 The DP proposes the creation of subclasses of financial liabilities to distinguish financial liabilities that provide equity-like returns from other financial liabilities. Accordingly, the DP suggests that entities should separately present financial liabilities that provide equity-like returns. That is, separately present financial liabilities for which the amount is dependent on the entity's available economic resources, including related returns. This would mean that:
  - a) For the **statement of financial performance** entities would be required to separately present income or expenses resulting from financial liabilities that provide equity-like returns in **OCI with no recycling.**
  - b) For the **statement of financial position** entities would be required to present this type of liabilities separately from other financial liabilities as **a separate line item.**
- 2.2 Finally, to help users of financial statements assess in more detail how any potential shortfall or surplus in economic resources is allocated among claims, the IASB suggests requiring the presentation of financial liabilities in **order of priority** on the face of the statement of financial position or in the notes.
- 2.3 For example, under the DP **shares redeemable at fair value** (which would not meet the exception in IAS 32 paragraphs 16A 16B) would be classified as financial liabilities as the entity may be required to redeem its own ordinary shares and transfer cash before liquidation. However, as the amount of the liability is linked to the value of the entity's shares, it provides equity-like returns. Therefore, if an entity performs well, the value of the share price will increase, the amount of the liability will increase and the entity would recognise a loss in OCI.
- 2.4 The DP explains that many consider that the recognition of such a loss(gain) in profit or loss (as in IAS 32) is **counter-intuitive.** The DP also explains that separate presentation requirements would **provide additional information to users of financial statements about financial instruments that are classified as financial liabilities but have characteristics of equity.** That is, the entity is required to deliver economic resources before liquidation but the amount of the liability depends on the entity's available economic resources and it provides an equity-like return. The DP details that providing information about the dependency of the amount of the liability on the entity's available economic resources (amount feature) through presentation would help users to assess balance-sheet solvency and returns.
- 2.5 In terms of the scope of the presentation requirements, the DP states that separate presentation requirements would apply to the following instruments:
  - a) Financial liabilities that contain an obligation for an amount that is dependent on the entity's available economic resources (e.g. shares redeemable at fair value);
  - b) Derivative financial assets and derivative financial liabilities that have net amounts unaffected by an independent variable (e.g. fair value written put options on own equity in the entity's functional currency); and
  - c) Partly independent derivatives that meet certain criteria (e.g. written call options on own equity in foreign currency).
- 2.6 Certain financial instruments are very complex in nature and contain both a host contract and an embedded derivative, often referred to as hybrid instruments. For such instruments the DP considered the approaches described in paragraph 2.14 below.

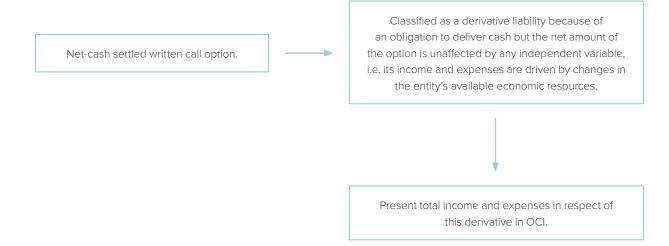
2.7 An illustration of how the presentation of the statement of financial position and statement of financial performance will change under the approach described in the DP is provided in Appendix 1 and Appendix 2.

Financial liabilities that contain an obligation for an amount that is dependent on the entity's available economic resources

- 2.8 For a non-derivative financial instrument classified as a financial liability, entities first need to consider whether the financial liability is for an amount which is dependent on the entity's available economic resources (e.g. shares redeemable at fair value depend on the value of the ordinary shares) to determine whether it should present:
  - a) This liability separately from other financial liabilities as a **separate line item in the statement of financial position**; and
  - b) The related income or expenses separately in OCI without recycling to profit or loss.

Derivative financial assets and derivative financial liabilities that have net amounts unaffected by an independent variable

- 2.9 For a derivative or an embedded derivative, entities first need to consider whether the net amount of the derivative is affected by an independent variable.
- 2.10 The presentation of derivatives and embedded derivatives for which the net amount is not affected by independent variables can be illustrated in the example below.



#### Partly independent derivatives

- 2.11 Certain derivatives on own equity are classified as a derivative liability because the net amount of the instrument is partly affected by an independent variable (e.g. foreign currency rate) and partly affected by the entity's available economic resources (e.g. share price). For example, the net amount of a foreign currency written call option (a contract to deliver a fixed number of the entity's own shares in exchange for a fixed amount of foreign currency) is partly affected by foreign currency and partly affected by the entity's share price. For partly independent derivatives, the DP discusses two approaches.
  - a) **Disaggregation approach:** an entity would split the income and expenses that result from the effect of the independent variables (that arise from changes in foreign currency) from those that result from the effect of dependent variables (that arise from changes in the value of the shares). Those that arise from independent variables would be presented in OCI.
  - b) **The criteria-based approach** (IASB's preferred approach): the separate presentation requirements would only apply to partly independent derivatives that meet particular criteria. This would mean that if the derivative meets certain criteria, then the entity would present in OCI the income and expenses that arise from the foreign currency and share price.
- 2.12 Accordingly, under the IASB's preferred approach (the criteria-based approach), if the derivative meets the specified criteria as per paragraph 2.13, then the total income and expenses of such derivatives are presented in OCI. This is illustrated as follows.

Foreign currency written
call option on own shares
(gross physically settled)

Classified as a derivative liability because
the net amount of the call option is affected by
an independent variable (foreign currency rate) but
its income and expenses would include the effect of
changes in the entity's available economic resources.

Assess whether the derivative meets the specified criteria.

If YES – Present total income and expenses separately in respect of this derivative in OCI.

If  ${\sf NO-Present}$  income and expenses in profit or loss.

2.13 Applying the criteria-based approach, an entity would present the total income and expenses arising from a partly independent derivative in OCI (including the portion that results from the effect of independent variables) if it meets the following criteria.

CRITERIA-BASED APPROACH			
Partly independent derivatives	Meets all the following criteria:		
	<ul> <li>The only independent variable affecting the net amount is a currency other than the entity's functional currency.</li> </ul>		
	The foreign currency exposure (FX) is not leveraged.		
	The FX exposure does not contain an option feature.		
	The FX denomination is imposed by an external factor.		

- 2.14 For instruments that contain a non-derivative financial liability and an embedded derivative (e.g. convertible bond), the DP considers two alternatives with regards to separate presentation:
  - a) Alternative A presentation requirements would apply only to embedded derivatives that are separated from the host and hybrid instruments that, as a whole, depend on the entity's available economic resources (e.g. shares redeemable at fair value); or
  - b) Alternative B the separate presentation requirements would apply to all embedded derivatives. This approach would require entities to separate all embedded derivatives for the purpose of applying the presentation requirements even if the hybrid contract as a whole is measured at fair value through profit or loss.

## CHAPTER 3: PRESENTATION OF EQUITY INSTRUMENTS

- 3.1 The DP discusses the creation of two subclasses of equity: 'Ordinary shares' and 'Other than ordinary shares'. For the latter, the DP suggests:
  - a) Expanding the existing requirements on attribution of total comprehensive income (i.e. profit or loss and OCI for the reporting period) to encompass different subclasses of equity instruments. Thus, under the IASB's preferred approach an entity would, in the statement of financial performance, attribute total comprehensive income to ordinary shares, non-cumulative preference shares, NCIs, warrants and any derivatives on own equity that are classified as equity; and
  - b) Updating each instrument's carrying amount directly through an attribution mechanism. This, together with the statement of changes in equity, would help users in assessing the allocation of residual returns among those equity instruments.
- 3.2 The DP explores different methods of attributing total comprehensive income to derivatives (e.g. warrants) and non-derivatives (e.g. non-cumulative preference shares) classified as equity.
- 3.3 When attributing total comprehensive income, the entity would:
  - a) First, attribute total comprehensive income to non-controlling interest as required at present under IAS 1.
  - b) Second, attribute the remaining amount of total comprehensive income to non-derivative equity instruments based on the calculation of basic earnings per share in accordance with IAS 33 *Earnings per Share*.
  - c) Attribute the remaining amount of total comprehensive income to derivative equity instruments which could be based on one of three possible methods (described below).
  - d) Finally, attribute the remaining income expenses to ordinary shares.

#### Allocation to non-derivative instruments

3.4 In the case of non-derivative equity instruments other than ordinary shares, the attribution should follow the existing calculation for basic earnings per share in IAS 33 and these amounts would be presented on the face of the statement of financial performance.

#### Allocation to derivative instruments

3.5 In the case of derivative equity instruments, the DP provides four alternatives. The IASB does not have a preliminary view about which of the alternatives would best balance the costs and benefits of improving information provided to users of financial statements. The first approach is to maintain current requirements on attribution and improve disclosure requirements. The remaining approaches are:

	FULL FAIR VALUE APPROACH	AVERAGE-OF-PERIOD APPROACH	END-OF-PERIOD APPROACH
Method	Attribute total comprehensive income to derivative equity instruments equal to the change in their fair value.	Use the average-of-period fair value ratio to apportion the entity's total comprehensive income for the period.	Reallocate the end-of-period fair value amount of equity among the various derivative equity instruments and ordinary shares so as to reflect the end-of-period ratio of fair values.
Key advantages	Similar information about changes in fair value of all derivatives on own equity regardless of their classification.	The amount attributed to the derivative equity instruments and ordinary shares is proportionate to their fair values.  Similar to the IAS 33 diluted EPS approach but uses the fair value instead of the strike price as a basis and takes into account both dilutive and anti-dilutive effects.	Might better depict the relative carrying amounts of the total of the different components of equity at the end of the period than other approaches.
Key disadvantages	Changes in fair value could exceed total comprehensive income, resulting in a negative amount being attributed to ordinary shares even when the entity made a profit.	Might not provide useful information about the end-of-period carrying amounts.	May not accurately depict distribution of returns during the period because changes in the carrying amounts of derivative equity instruments would include catch-up and other adjustments.

- 3.6 Under the full fair value approach, the total comprehensive income attributed to the warrants and forward contracts are represented by the change in their respective fair values.
- 3.7 Under the average-of-period approach, the average fair value of the ordinary shares, warrants and the forward contracts are weighed and the ratio is applied to the *total comprehensive income for the period*.
- 3.8 Under the end-of-period approach, the fair value at the end of the year of the ordinary shares, warrants and the forward contracts are weighed and the ratio is applied to the *carrying amount of net assets at year end*.
- 3.9 An Illustrative example is included in Appendix 3.

## CHAPTER 4: DISCLOSURE OF FINANCIAL INSTRUMENTS

- 4.1 The DP states that providing the following information would be useful to users of financial statements:
  - a) Information about the priority of financial liabilities and equity instruments on liquidation. Entities could choose to present financial liabilities and equity instruments in order of priority, either on the statement of financial position, or in the notes.

ILLUSTRATIVE EXAMPLE ON PRIORITY OF CLAIMS	201x
Senior secured loan	2,500
Junior secured loan	1,500
Subordinated note(s)	1,000
Finance leases	450
Pension plan deficit	500
Other financial liabilities	500
Liabilities	6,450
Non-cumulative preference shares	1,000
Non-controlling interest	415
Shareholders' equity	1,350
Total group equity	2,765
Total capitalisation	9,215

- b) Information about potential dilution of ordinary shares. These disclosures would include potential dilution for all potential issuances of ordinary shares. The following table illustrates a reconciliation of changes in:
  - (i) The number of ordinary shares outstanding; and
  - (ii) The maximum number of additional potential ordinary shares that could be issued during the period.

	ORDINARY SHARES OUTSTANDING	MAXIMUM ADDITIONAL 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	200 000	-
1 June 20x1 – Conversion of bonds	20 000	(20 000)
1 September 20x1 - Exercise of warrants	400 000	(400 000)
31 December 20x1	5 620 000	1080000

c) Information about terms and conditions should be provided for both financial liabilities and equity instruments in the notes to the financial statements.

# APPENDIX 1 – ILLUSTRATIVE EXAMPLE FOR A STATEMENT OF FINANCIAL PERFORMANCE

An illustrative example developed by EFRAG for the statement of financial performance is presented below. The objective of the example is to illustrate the presentation requirements and not how the entity's performance and income tax would change.

#### **IAS 32**

OR LOSS	20X2	20X
Revenue	10 000	10 000
Employee wages and salaries	(9 000)	(9 000
Interest on bonds	(232)	(232
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:		
	565	73
attributable to: Owners of company Non-controlling interest	23	73: 3
attributable to: Owners of company Non-controlling interest  STATEMENT OF PROFIT O COMPRENSIVE INCOME  Profit for the year	23	3
attributable to: Owners of company Non-controlling interest  STATEMENT OF PROFIT O COMPRENSIVE INCOME	23 R LOSS AND (	3 DTHER
attributable to: Owners of company Non-controlling interest  STATEMENT OF PROFIT O COMPRENSIVE INCOME  Profit for the year  Total other	23 R LOSS AND (	3 DTHER
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attributable to: Owners of company Non-controlling interest  STATEMENT OF PROFIT O COMPRENSIVE INCOME  Profit for the year  Total other comprehensive income  Total comprehensive income  Total comprehensive income	23  R LOSS AND (  588	768

#### IASB'S PREFERRED APPROACH

10 000 (9 000) (232)
, ,
, ,
(232)
-
768
707
737
31
-
-
-
-
-
- - 768
- - 768
- - 768
768
656

## APPENDIX 2 – ILLUSTRATIVE EXAMPLE FOR A STATEMENT OF FINANCIAL POSITION

An illustrative example developed by EFRAG is presented below for the statement of financial position for an entity presenting more than the two minimum line items required by IAS 1. The objective of the example is to illustrate the presentation requirements and not on how the entity's financial position would change

#### **IAS 32**

FINANCIAL POSITION	20X2	20X
Property, plant and		
equipment	44 000	44 000
Cash	1768	1000
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	1000
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 (right issue)	1 000	1 000
Warrents (fixed-for-fixed)	2 000	2 000
Non-cumulative preference shares	2 000	2 000
Non-controlling interest	1024	1000

#### IASB'S PREFERRED APPROACH

STATEMENT OF FINANCIAL POSITION	20X2	20X1
Property, plant and equipment	44 000	44 000
Cash	1778	1 010
Total assets	45 778	45 010
Non-current liabilities		
Ordinary bonds	9 000	9 000
Share-settled bonds (new rational for classification)	3 000	3 000
Commodity indexed forward contract	4 050	4 000
Cumulative preference shares (new classification)	2 060	2 000
Foreign currency written call option	1050	1000
Current liabilities		
Shares redeemable for their fair value	1080	1000
Total liabilities	20 240	20 000
Ordinary shares	15 000	15 000
Retained earnings	3 380	2 900
Other comprehensive income (from ordinary shares and other)	(30)	100
Other than ordinary shares		
Derivative classes of equity (attribution 3 methods)		
- Warrants (fixed-for-fixed)	2 050	2 000
- Net-share settled Forward sell shares (new classification)	2 050	2 000
- Embedded derivative in compound instrument	11	10
Other non-derivative classes of equity (attribution IAS 33)		
- Non-cumulative preference shares	2 056	2 000
Non-controlling interest	1 021	1 000
Total Equity	25 538	25 010

## APPENDIX 3 — ILLUSTRATIVE EXAMPLE ON ATTRIBUTION REQUIREMENTS

An illustrative example developed by EFRAG for the statement of financial performance is presented below. The objective of the example is to illustrate the different attribution approaches and not how the entity's performance and income tax would change.

STATEMENT OF PROFIT OR LOSS	NO	FULL FAIR	END-OF-	AVERAGE-
IN MONETARY UNITS	ATTRIBUTION	VALUE	PERIOD	OF-PERIOD
Income	20 000	20 000	20 000	20 000
Expenses	(5 000)	(5 000)	(5 000)	(5 000)
Net results	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	1000	1000	1000	1000
Warrants: number of shares to be issued	1000	1000	1000	1000
Full fair value				
Changes in fair value of warrants		5 000		
End-of-period approach				
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 the	eir relative fair value at ye	ear end	7 692	•
Carrying amount of warrants at beginning of the year	ear		5 000	
Amount attributed to warrants (100 000 x 7.69% - 5	5 000	-	2 692	-
Average-of-period approach				
Average fair value of ordinary shares over the year				110 00
Average fair value of warrants over the year				7 50
Total				117 50
Weight of warrants				6.38
Net result at year end				15 00
Amount attributed to warrants (15 000 x 6.38%)				95

