The changing future of financial instruments accounting

This article aims to:

- Discuss the key features of the discussion paper on financial instruments with characteristics of equity published by IASB.

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Recently, the International Accounting Standards Board (IASB) issued a discussion paper DP/2018/1 - *Financial Instruments with Characteristics of Equity* (FICE). This discussion paper aims to improve the information companies provide in their financial statements about financial instruments they have used. Therefore, the discussion paper focusses on defining the principles for the classification of financial liabilities and equity instruments, and does not intend to fundamentally change the existing classification requirements.

The discussion paper outlines a suggested approach with an aim to help companies issuing financial instruments to classify them as either debt or equity and providing investors with better information about such instruments.

The IASB's proposed approach is based on two features, i.e. timing feature and amount feature, and would provide additional information relating to financial liabilities and equity instruments through separate presentation of income and expenses on the face of financial statements and additional disclosure in the notes to the financial statements.

The period to provide comments to the discussion paper ends on 7 January 2019.

Background

IAS 32, *Financial Instruments: Presentation* establishes principles for distinguishing financial liabilities from equity instruments. It applies to the classification of financial instruments as financial assets, financial liabilities or equity instruments. The distinction between a liability and equity plays a significant role in how entities provide information in their financial statements. For example, changes in the carrying amount of a financial liability would be recognised in the statement of profit and loss whereas change in equity would not.

Currently, the entities are applying the requirements of IAS 32 to a financial instrument to classify such instrument either as a financial liability or an equity instrument.

It was observed that the classification requirements of IAS 32 result in significant practice issues when applied to complex financial instruments such as instruments combining features of both bonds and ordinary shares (new forms of financing). In the past, IFRS interpretation committee has received several queries in this area and referred some of these cases to IASB.

On the basis of the queries received and to address the emerging issues regarding the classification of financial liabilities, IASB decided to develop the FICE project. The project discusses the classification of financial instruments from the perspective of the issuer, as financial liabilities or equity instruments. Further, the 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.*

What's the issue?

The classification of financial instruments as liabilities or equity instruments has a significant impact on presentation in the financial statements, on their measurement and on how they affect an entity's financial performance. However, the increasing complexity of financial instruments is making it difficult to distinguish between liabilities and equity. The IASB observed following challenges relating to current classification requirements:

- IAS 32 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 in relation to features of the financial instruments.

Proposal under the discussion paper

Classification principles

The IASB has proposed an approach which establishes principles for classification of financial instruments by reference to two features that are regarded as important i.e. the timing feature and amount feature.

According to the proposed approach, a financial instrument would classify as a financial liability if it contains:

a. An unavoidable contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation (the timing feature), and/or
b. An unavoidable contractual obligation for an amount independent of the entity's available economic resources (the amount feature).

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

The proposed approach requires an entity to analyse the above mentioned features to find the correct classification of financial instruments. Information about

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to make assessments that will inform their decisions about providing resources to the entity.

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

Amount feature / Timing feature	Obligation for an amount independent of the entity's available economic resources	No obligation for an amount independent of the entity's available economic resources
Obligation to transfer cash or another financial asset at a specified time other than at liquidation	Liability (e.g. simple bonds)	Liability (e.g. shares redeemable at fair value)
No obligation to transfer cash or another financial asset at a specified time other than at liquidation	Liability (e.g. 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 (e.g. ordinary shares)

(Source: IASB's Discussion Paper DP/2018/1 - *Financial Instruments with Characteristics of Equity* issued in June 2018)

The above defined approach requires two broad assessments of financial position and financial performance that depend on information about different sets of features of claims. They are:

a. Assessments of funding liquidity and cash flows, including whether an entity will have the economic resources required to meet its obligations as and when they fall due. These assessments are driven by information about requirements to transfer economic resources at a specified time other than at liquidation (the timing feature)

b. Assessments of balance sheet solvency and returns (measured on an accrual basis), including whether an entity has sufficient economic resources required to meet its obligations at a point in time, and whether the entity has produced a sufficient return on its economic resources to satisfy the return that its claims oblige it to achieve. These assessments are driven by information about the amount of the obligation (the amount feature).

Classification of derivatives

The IASB developed separate classification principles to apply the proposed approach to derivative financial instruments 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. The discussion paper proposes that such a derivative may be classified as an equity instrument, a financial asset or a financial liability in its entirety.

Further, IASB proposes that such a derivative on own equity would be classified as a financial asset or a financial liability if:

- It is net-cash settled i.e. the derivative could require the entity to deliver cash or another financial asset, and/or contains a right to receive cash, for the net amount at a specified time other than at liquidation (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 (amount feature).

Presentation

The discussion paper proposes a new approach that 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 the statements of financial position and financial performance; and
- Information about equity instruments that would be provided by attributing total income and expense to equity instruments other than ordinary shares.

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Disclosures

The IASB's proposed 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.

Further, IASB proposes following improvements to the disclosure requirements for financial liabilities and equity instruments:

- Priority on liquidation i.e. each class of financial liabilities and equity instruments ranked in order of priority on liquidation.
- Potential dilution of ordinary shares i.e. 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.
- Contractual terms and conditions i.e. 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.

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Issues addressed by IASB's proposed approach

Challenges	Applying the proposed 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 as described above. In particular, the approach would clarify that, for a derivative to be classified as equity, the net amount of the derivative would 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, e.g. convertible bonds and written put options 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.
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 stand-alone 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 (e.g. 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.

(Source: IASB's Discussion Paper June 2018 | Snapshot: Financial Instruments with Characteristics of Equity)

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Next steps

The discussion paper is open for public comments and IASB seeks comments on the financial reporting challenges discussed in the discussion paper and possible approaches to address the challenges. The IASB also seeks comments on the proposed approach and whether it should be developed to address the challenges identified.

The IASB would consider the comments received on the discussion paper to decide for further course of action and accordingly develop an exposure draft to amend the existing requirements.

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