

Beyond the GAAP

Mazars' newsletter on accounting standards

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Editorial

This issue of Beyond the GAAP brings a piece of good news for our readers, as we all return to work following a well-deserved break: our financial instruments experts have saved you some effort by reading and summarising the IASB's particularly dense Discussion Paper on the classification of financial instruments as liabilities or equity, published at the beginning of the summer. See our 'A Closer Look' feature for our summary of the DP.

Finally, a spot of revision to help you get back into the swing of things: our crossword this month is a compilation of clues from previous crosswords.

Welcome back and happy reading!

Edouard Fossat

Isabelle Grauer-Gaynor

IFRS highlights

Implementation of IFRS 9 by European insurers

In August, Mazars published a benchmark study of 16 European insurance and reinsurance groups, and 10 European bank insurers, based on their financial reporting at the end of 2017. The study looks at how they intend to implement IFRS 9 (in 2018 or deferred to a later date) and the expected impacts of first-time application of the standard.

The study found that 94% of the sample of insurance and reinsurance groups intend to defer application of IFRS 9 to 2021, when it will be implemented concurrently with IFRS 17 – *Insurance Contracts*. Furthermore, 27% of the groups presented disclosures on the level of their predominance ratio for insurance activities. Finally, only five groups specified which of the phases of IFRS 9 they expected would have the greatest impact (classification and measurement, impairment, and/or hedge accounting).

The full study is available via the following link:
<https://www.mazars.com/Home/News/Latest-News3/Benchmark-Study-on-European-Insurers-IFRS-9>

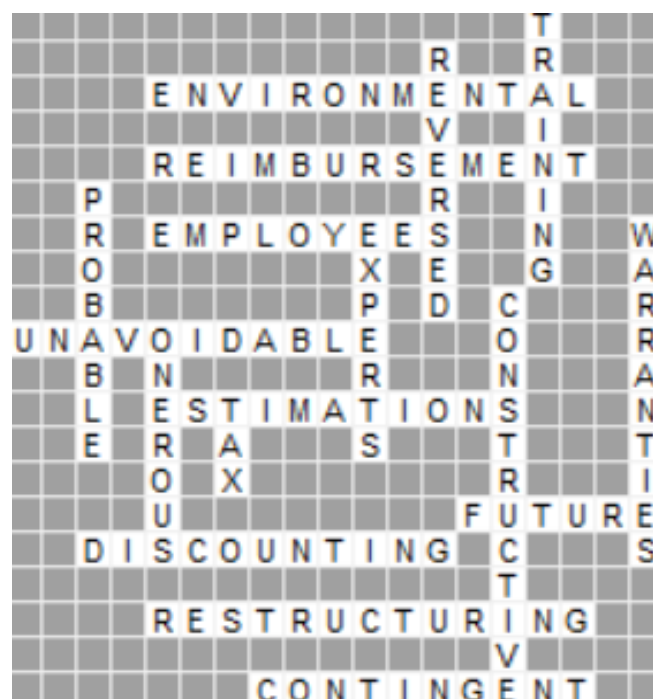
IFRS Foundation consults on length of service for Trustee Chair and Vice-Chairs

On 19 June 2018, the IFRS Foundation published a consultation with a view to permitting its Chair to serve up to three terms of three years each, irrespective of whether they are recruited from the ranks of the Trustees or externally. Vice-Chairs, recruited from among the Trustees, would also be permitted to serve three terms of three years each. This proposal would have the benefit of continuity and would enable the Foundation to profit from the appointees' experience.

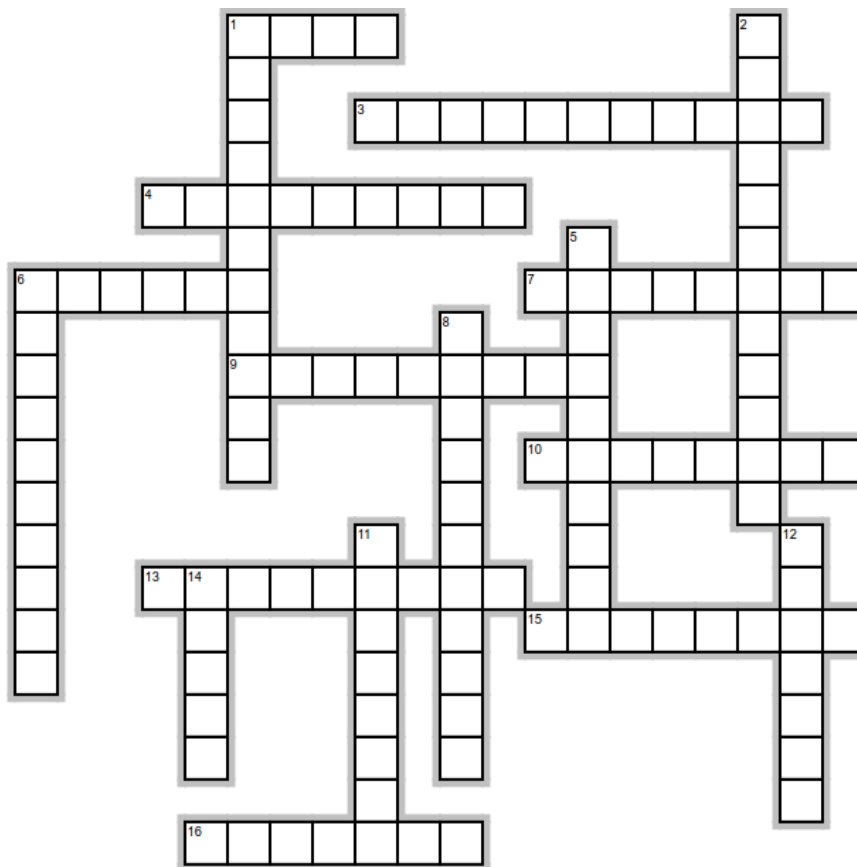
Another proposed amendment would permit a Trustee who has served their maximum term to be reappointed after six years have elapsed, for a three-year term renewable only once.

The IFRS Foundation's consultation was open until 17 September 2018.

Crossword: last month's solution



Crossword: Review of past crosswords



Across

1. In such an acquisition, the parent must remeasure the equity instruments previously held in the acquiree at fair value, and recognise any gain or loss in profit or loss
3. In addition to presentation, other type of impact of IFRS 5
4. Value at which options granted are measured if their fair value cannot be measured reliably
6. Is to be taken into account to assess the lease term
7. This type of assessment of credit risk shall be carried out to determine whether there has been a significant increase
9. Entities that predominantly undertake activities in this sector may defer application of IFRS 9 to 1 January 2021
10. This type of cost cannot be included in the costs of an item of property, plant & equipment
13. Entity which controls goods or services before they are transferred to the customer
15. Control of one entity over another is assessed on its ability to direct this type of activity of the investee
16. An entity shall take account of the tax rates that have been (substantively) _____ at the end of the reporting period

Down

1. Description of a right that the holder has the practical ability to exercise
2. IFRS 12 also requires disclosures on involvement with structured entities that are not this
5. An entity's unconditional right to receive consideration under a contract with a customer.
6. Entities shall maximise the use of such inputs when measuring fair value
8. The subject of the last Practice Statement published by the IASB in September 2017
11. Only such promised goods or services may be accounted for as separate performance obligations
12. Second criterion of the definition of a lease contract
14. As well as information on the nature and impact of the interests held in other entities, disclosures are also required on these aspects associated with these interests

A Closer Look

FICE Discussion Paper: the Board's preferred approach to classifying financial instruments as liabilities or equity

On 28 June, the IASB published a Discussion Paper (DP) presenting the current state of its deliberations on the *Financial Instruments with Characteristics of Equity* project (FICE). This project, which is not being carried out in conjunction with the FASB, focuses on the classification of financial instruments as liabilities or equity in the issuer's financial statements. The comments received will help the Board to decide whether to publish an exposure draft to amend or replace IAS 32, and/or non-mandatory implementation guidance.

Here, *Beyond the GAAP* summarises the key concepts presented in the DP, with a particular focus on the questions on which the Board is seeking feedback in order to decide between the various possible approaches.

1. Objectives of the DP

Like IAS 32, the scope of the DP is limited to the principles for classifying financial instruments as liabilities or equity from the point of view of the issuer of the instruments [IN2]. Thus, the presentation and measurement principles set out in IFRS 9 – *Financial Instruments* will not be affected by this DP.

The IASB has identified a number of areas where the current IAS 32 requires improvement. In particular, it wishes to clarify the underlying concepts used to distinguish between liabilities and equity. The Board notes that this lack of clarity has resulted in divergences in the accounting treatment of certain products, such as puts on non-controlling interests or certain types of contingent convertible bonds. Furthermore, the situation makes it difficult to identify the correct accounting treatment for new and increasingly complex financial instruments that are appearing on the market, which combine features of both liabilities and equity.

The IASB has also taken account of feedback from users of financial statements, who have asked for further

information to be provided on the features of this type of financial instruments.

The Board wished to address these specific issues without making changes to the classification outcomes for the majority of instruments, which are less complex.

The main objectives of the FICE project are as follows:

- to define clear conceptual principles that are consistent with the current IAS 32;
- to improve the consistency of the classification of contractual rights/obligations linked to an entity's own equity instruments;
- to improve the information provided (through presentation in the financial statements and disclosures in the notes) about features of financial instruments that are not captured by their classification as liabilities or equity.

2. Summary of the classification approach proposed in the DP

The Board's current preferred approach for classifying a financial instrument as a liability or equity is based on the two following features:

- *Timing feature*: there is an unavoidable obligation to transfer economic resources (cash or another financial asset) at a specified time other than at liquidation;
- *Amount feature*: there is an unavoidable obligation to transfer an amount independent of the entity's available economic resources[†].

Instruments may only be classified as equity instruments if they possess neither of these features. Otherwise, they are classified as financial liabilities.

These principles are summarised in the table below[‡].

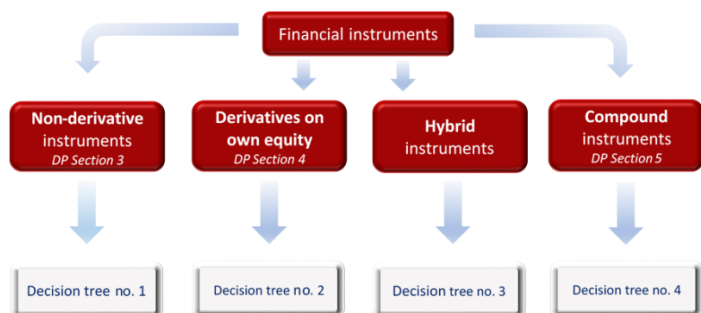
[†] See below for more details.

[‡] IASB DP FICE § 2.36

Distinction based on amount 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)
Distinction based on timing feature		
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)

These general principles are then applied to four types of instruments: non-derivative instruments, derivative instruments, hybrid instruments[§] and compound instruments^{**}.

Our discussion of the application of the principles will be presented as follows:



The Board has also reasserted that only contractual requirements should be taken into account in its preferred approach. Thus, if an obligation to remit cash arises from a legal requirement (rather than a contractual requirement), this would not be taken into account when classifying the financial instrument.

IFRIC 2 is an exception to this. The provisions of this interpretation relating to members' shares in co-operative entities and similar instruments are expected to remain unchanged.

The concept of “an amount independent of the entity’s economic resources”

For the purposes of the “amount feature”, the entity’s economic resources are defined as the total recognised and unrecognised assets of the entity, minus the recognised and unrecognised claims against the entity (with the exception of the instrument in question). Thus, the concept of “economic resources” covers more than just the elements recognised in the balance sheet.

An amount is deemed to be “independent of the entity’s available economic resources” if:

- it does not change as a result of changes in the entity’s available economic resources (for example: it is a fixed amount, or it is indexed to an interest rate, or it is linked to only part of the entity’s economic resources, e.g. indexed to the value of a specified asset or to EBIT); or
- it changes as a result of changes in the entity’s available economic resources but does so in such a way that the amount could exceed the available economic resources of the entity (e.g. due to leverage).

The fair value of the entity’s ordinary shares is an example of a variable that is dependent on the entity’s economic resources.

Principles retained from IAS 32

The Board’s preferred approach maintains its position on economic compulsion, i.e. it is not taken into account. In other words, only contractual obligations are taken into account in this approach to liabilities/equity classification. However, the Board may retain the provisions set out in paragraph 20 of IAS 32, which allow some flexibility on this point.

[§] A hybrid instrument is an instrument with a derivative component and a non-derivative component.

^{**} A compound instrument is an instrument with a liability component and an equity component.

3. Applying the classification approach to non-derivative financial instruments

How the approach applies to non-derivative instruments

At this stage, the IASB proposes that a non-derivative instrument should be classified as a financial liability if it contains [3.8]:

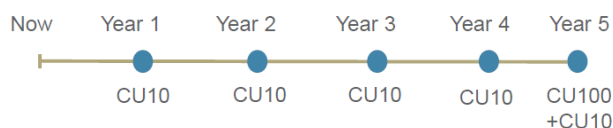
- an unavoidable **contractual** obligation to transfer **cash** (or another financial asset) at a specified time other than at liquidation (*timing feature*); **and/or**
- an unavoidable **contractual** obligation for an amount **independent** of the entity's available economic resources (*amount feature*).

Examples of how this applies to some typical instruments in this category

To illustrate this approach, we reproduce below some of the examples discussed by the IASB in its webcasts. We will begin with two very simple examples.

Example 1 from webcast no. 2:

An entity issues an instrument for 100, containing an obligation to pay an annual coupon of 10 for five years and an obligation to repay the principal amount of 100 at the end of year 5.



Should it be classified as liability or equity?	
Timing Feature	Any obligation to transfer cash before liquidation? <input checked="" type="checkbox"/>
Amount Feature	Return on instrument independent? <input checked="" type="checkbox"/>

Liability

In this simple example, the obligation to make coupon payments and repay the principal amount of 100 at maturity means the instrument meets the criterion for the timing feature. It also meets the criterion for the amount feature, as the amount to be paid is fixed and is thus by definition independent of the entity's economic resources.

Example 2 from webcast no. 2:

An entity issues an instrument for 100 today. The instrument contains an obligation to issue 110 own shares in one year's time, with no interim coupon payments.



Should it be classified as liability or equity?	
Timing Feature	Any obligation to transfer cash before liquidation? <input type="checkbox"/>
Amount Feature	Return on instrument independent? <input type="checkbox"/>

Equity

Timing feature: this criterion is not met:

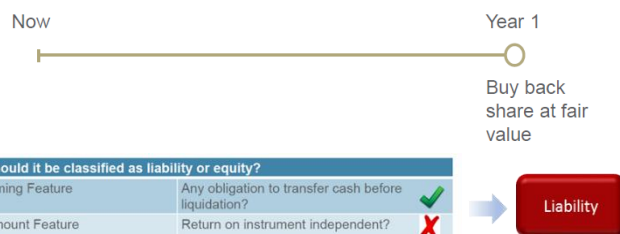
- the entity has no obligation to transfer cash (or another financial asset held by the entity)
- the obligation to transfer own shares does not meet this criterion, as these own shares do not form part of the entity's assets.

Amount feature: this criterion is not met. The amount to be transferred is completely dependent on the entity's available economic resources and cannot exceed them.

The following example demonstrates that the IASB's preferred approach continues to place more emphasis on contractual rights and obligations than on the form or denomination of the instrument.

Example 4 from webcast no. 2:

An entity issues shares for 100 today. The shares contain an obligation to buy them back in one year's time for their fair value in cash on this date.



Timing feature: this criterion is met. There is indeed an obligation to transfer cash in one year's time.

Amount feature: this criterion is not met. The amount is completely dependent on the entity's available economic resources as it is based on the fair value of the entity's own shares.

Example 5 from webcast no. 2:

An entity issues an instrument for 100, containing an obligation to pay interest at 10% a year and to repay the principal amount of 100 at liquidation. The entity may, at its discretion, defer payment of interest indefinitely until liquidation; however, the deferred amounts will themselves accrue interest.

Should it be classified as liability or equity?	
Timing Feature	Any obligation to transfer cash before liquidation? ✗
Amount Feature	Return on instrument independent? ✓

➔ Liability

Although the instrument contains no obligation to transfer cash prior to liquidation, the amount due at this date is predetermined and is independent of the entity’s available economic resources at this date. The approach presented by the Board in this DP would thus require the entity to classify this instrument as a financial liability. This is one of the instances in which the proposed approach differs from the current IAS 32, which would require the entity to classify the instrument as equity based on the fact that there is no obligation to pay cash.

Exception retained for puttable instruments

IAS 32 includes an exception that permits certain puttable instruments with particular characteristics to be classified as equity even though they meet the definition of a financial liability (cf. IAS 32 para. 16A to 16D).

The Board’s preferred approach, as outlined in the DP, is to retain the puttable exception, for reasons similar to those behind the publication of the amendment to IAS 32 in 2008.

The Board acknowledges that classifying these (very specific) puttable instruments as equity does not provide the information required by users of financial statements, particularly as regards liquidity. However, the Board believes that this drawback would be mitigated by retaining the disclosure requirements set out in IAS 1 para. 136A.

Financial liabilities: separate presentation of obligations to transfer amounts that are dependent on the entity’s economic resources

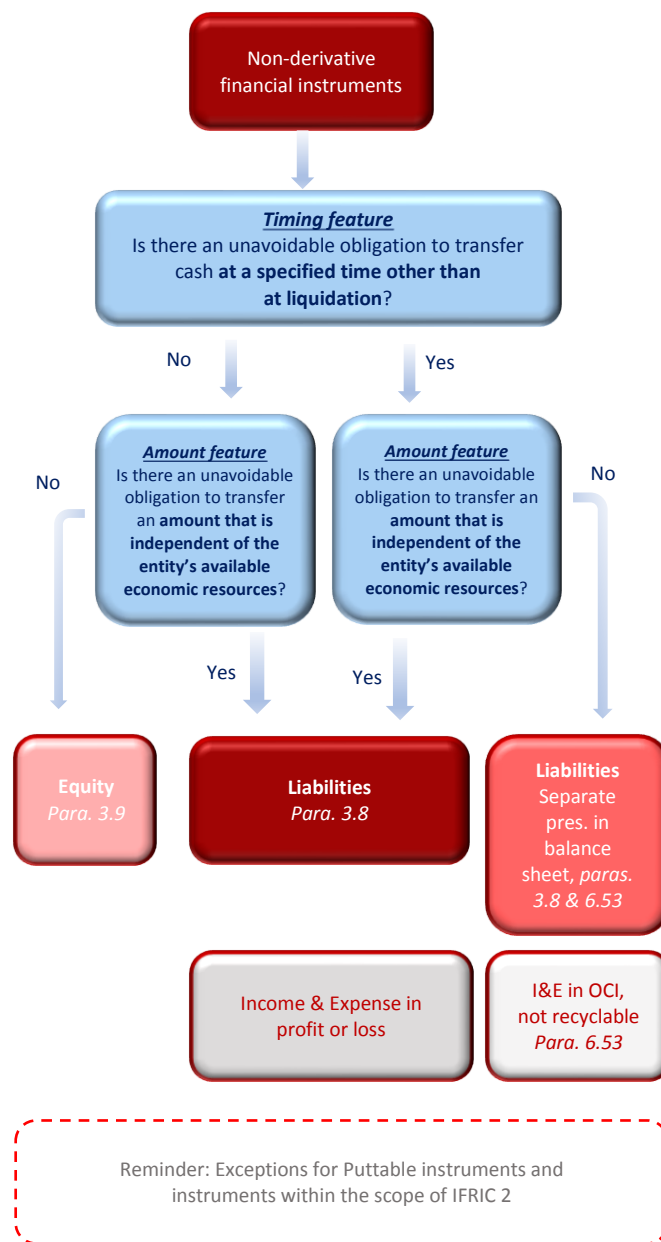
In addition to this general approach to the classification of liabilities and equity, the Board proposes introducing new presentation requirements to make it easier for users to analyse solvency or profitability based on the information provided in the balance sheet and the statement of comprehensive income.

Thus, instruments that are classified as financial liabilities because they possess the “timing” feature, but not the amount feature as they contain an obligation to transfer an amount that is dependent on the entity’s available economic resources, would be:

- presented separately in the balance sheet; and
- their related income and expense would be recognised in other comprehensive income (OCI). This income and expense would not be recyclable, i.e. it would not be

subsequently reclassified to profit or loss. [DP para. 6.53].

Decision tree no. 1: Non-derivative financial instruments



4. Applying the classification approach to derivatives on own equity [DP section 4]

Derivatives within the scope of this section

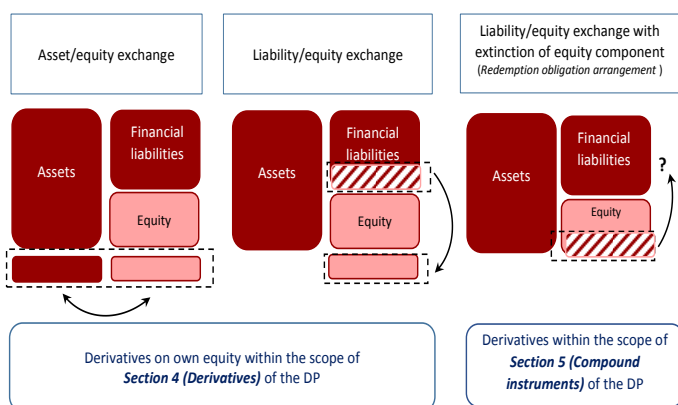
First, a reminder that a derivative always involves a contractual right and/or contractual obligation **to exchange** financial assets, financial liabilities and/or equity instruments with another party. Thus, a derivative could be described as an exchange contract that has two “legs”, with each leg representing one side of the exchange.

In the context of this DP, derivatives on own equity are:

- derivatives that will be settled in whole or in part in own equity; or
- derivatives where the underlying of one of the “legs” is the entity’s own equity.

The DP identifies three broad types of derivatives on own equity:

- **Asset/equity exchanges:** these are contracts to receive cash (or another financial asset) in exchange for delivering own equity instruments.
- **Liability/equity exchanges in which the equity component is not extinguished:** these are contracts to extinguish a financial liability in exchange for delivering own equity instruments.
- **Liability/equity exchanges in which the equity component is extinguished.** The DP also refers to these contracts as “redemption obligation arrangements”.



The approach described in part 4 of this article below applies to all derivatives that are recognised separately (irrespective of whether they are standalone financial instruments or embedded derivatives recognised separately) with the exception of derivatives that may require the extinguishment of equity instruments.

The accounting treatment of derivatives in which the equity component is extinguished (*redemption obligation arrangements*) is addressed in the section on compound instruments.

Main principles of the classification approach for derivatives on own equity

Once again, the Board is here seeking to clarify the principles for classifying derivatives on own equity, without making fundamental changes to the classification outcomes under IAS 32.

The first key principle, which is carried over from IAS 32, is that a derivative on own equity should be classified in its entirety as an equity instrument, a financial asset or a financial liability (i.e. the two “legs” of the exchange are classified together) [4.38].

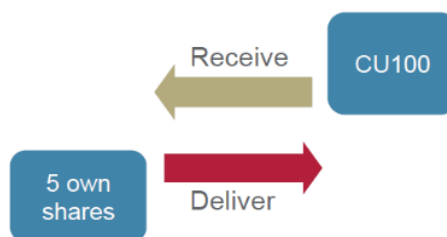
Thus, a derivative on own equity would be classified in its entirety as either a financial asset or a financial liability if:

- **Timing feature:** the derivative is settled net in cash (or another financial asset) at a specified time other than at liquidation; **and/or**
- **Amount feature:** the net amount of the derivative is affected by a variable that is independent of the entity’s available economic resources.

The examples below, taken from the IASB’s webcast, emphasise the importance of how the derivative is settled in the classification approach set out in the DP:

Gross-settled derivative

Written option to sell 5 own shares for CU100, gross physically settled.

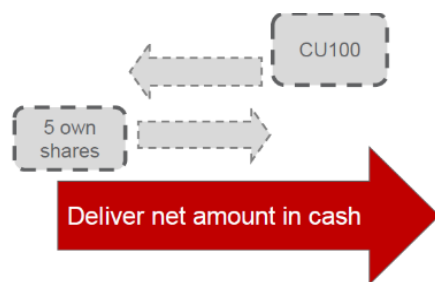


Would it be classified as a derivative asset/liability or equity?	
Timing Feature	Net amount creates an obligation to transfer cash? X
Amount Feature	Net amount affected by any variable other than own share price? X

Equity

Net-cash-settled derivative

Written option to sell 5 own shares for CU100, net cash settled.



Would it be classified as a derivative asset/liability or equity?	
Timing Feature	Net amount creates an obligation to transfer cash?
Amount Feature	Net amount affected by any variable other than own share price?

Financial liability

Extracts from webcast no. 3 on the classification of derivatives on own equity.

Note that, if there is a choice as to how the derivative is settled, the obligation shall be considered from the point of view of the entity. Thus, in the example above, if the other party has the choice as to how the derivative is settled, the instrument shall be classified as a financial liability. In contrast, if the entity has the choice as to how the derivative is settled, the instrument shall be classified as equity. This differs from IAS 32, which prohibited an instrument from being classified as equity if one of the possible settlement options would result in it being classified as a financial asset or liability.

More details on the concept of an “independent variable”

As we have seen above, a derivative on own equity may only be classified as equity if the net amount of the derivative is not affected by a variable that is independent of the entity’s available economic resources (*amount feature*).

The Board holds that the following variables should always be considered to be independent:

- amounts indexed to a variable that is independent of the entity’s performance (such as the price of a commodity);
- fixed amounts in a currency other than the functional currency of the entity issuing the shares [DP paras. 4.49-50];
- amounts that depend on all or part of the entity’s resources, such as EBIT [DP para. 4.52]. Here, not all of the entity’s obligations are taken into account, and thus

the net amount of the derivative could be significant even if the entity makes a net loss.

However, the Board has relaxed the definition of an independent variable to take account of certain inherent characteristics of derivatives on own equity:

▪ The time value of money:

One might initially assume that interest rates would be considered to be variables that are independent of the entity’s available economic resources. However, the definition of a derivative in IFRS 9 stipulates that it is settled at a future date. Thus, the effect of discounting (and thus sensitivity to interest rates) must be taken into account when measuring the net value of the derivative.

As a result, if this criterion were to be applied strictly, all derivatives would be affected by at least one independent variable and thus no derivative could ever be classified as equity. The Board has thus proposed that interest rates should not be considered in the analysis.

However, this only applies to simple instruments. Any structured element, such as leveraging or a risk that is not linked to the derivative (e.g. a benchmark interest rate in a currency that differs from that of the underlying), shall be treated as an independent variable [DP para. 4.53].

▪ Anti-dilution provisions:

The existence or the lack of anti-dilution provisions does not affect the classification of the instrument, provided that the provision does not introduce an independent variable. Essentially, anti-dilution provisions aim to put the holder of the instrument in the same position as a holder of ordinary shares. Thus, this type of provision would not preclude classification of the instrument as equity.

Whether the provision is asymmetric (i.e. protecting solely against dilution) or symmetric (i.e. adjusting for both increases and decreases in the total number of shares) does not in and of itself determine whether an anti-dilution provision is independent [DP paras. 4.55-58].

▪ Dividends/distributions to holders of ordinary shares:

By definition, dividends are dependent on the entity’s economic resources. The accounting treatments for contractual terms of this type and for anti-dilution provisions will be the same [DP paras. 4.59-61].

▪ Contingencies:

The exercise of an option derivative may be at the option of the entity, the holder, or contingent on an external event beyond the control of either the holder or the issuing entity. In the latter two cases, the entity does not have control over the settlement of the derivative.

If the entity does not have the right to avoid a settlement outcome that would result in classification of the instrument as a financial asset or liability, the instrument in its entirety shall be classified as a financial asset or liability. Similarly, if a contingency introduces an independent variable that has an effect on the net amount of the derivative, the derivative shall be classified as a financial asset or liability. Conversely, contingencies that do not affect either the *timing feature* or the *amount feature* do not affect the classification of the derivative [DP paras. 4.63-66].

▪ **Derivatives on non-controlling interests:**

The Board's proposed approach for derivatives on own equity is applied in the same way to puts on non-controlling interests (see also below for the specific case of written put options on own equity instruments).

Partly independent derivatives: a specific case

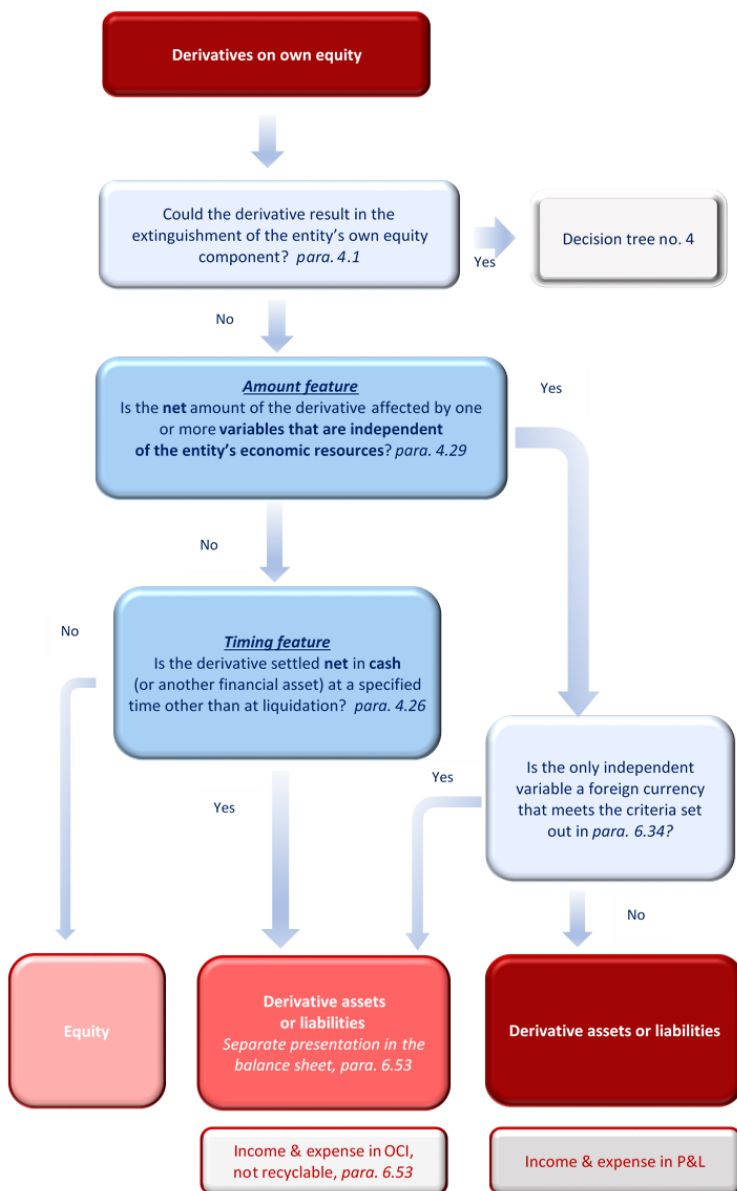
Partly independent derivatives are those whose net amounts are affected by both variables that are independent of the entity's economic resources, and variables that are dependent on the entity's economic resources. The Board's preferred approach is to classify them as financial assets or financial liabilities. Classifying these derivatives as equity would not be permitted [DP paras. 4.32 et seq.].

Some derivatives on own equity require separate presentation and impact on OCI

As a complement to the classification approach, the Board is proposing that some derivatives that contain no obligation for an amount that is independent of the entity's economic resources shall be presented separately in the balance sheet, and related income and expenses shall be recognised in OCI without subsequent recycling to profit or loss [DP para. 6.53]. This is consistent with the presentation required for non-derivative instruments.

These requirements apply to the following two types of derivatives:

- derivatives classified as financial assets or financial liabilities with a net amount (i.e. both legs) that is totally dependent on the entity's economic resources; and
- partly independent derivatives, where the only independent variable is a foreign currency (and where the foreign currency exposure is not leveraged and does not contain an option feature, and the currency denomination is required by an external factor such as a law or regulation [DP para. 6.34]).



Decision tree no. 2: Derivatives

5. Hybrid instruments containing an embedded derivative on own equity

Readers will remember that, in IFRS 9, a hybrid instrument is defined as an instrument comprising a non-derivative host and an embedded derivative. For an instrument to be in this category, all its characteristics must have been assessed and no equity component must have been identified.

The approach set out in the DP does not make any changes to the accounting treatment of these hybrid instruments:

- if the host contract is a financial asset, the hybrid instrument as a whole is classified as at fair value through profit or loss;
- if the host contract is a financial liability, the embedded derivative is recognised separately, unless the entity opts to measure the instrument as a whole at fair value through profit or loss (FV-PL).

If an embedded derivative on own equity is recognised separately, the accounting treatment shall be the same as for a standalone derivative on own equity. However, the Board is considering the options for presentation in the balance sheet of hybrid instruments that contain an embedded derivative on own equity, where the instrument as a whole is measured at fair value through profit or loss. In practice, this will relate to situations in which the entity has elected to apply the fair value option, which permits the instrument as a whole to be measured at fair value through profit or loss rather than recognising the embedded derivative separately.

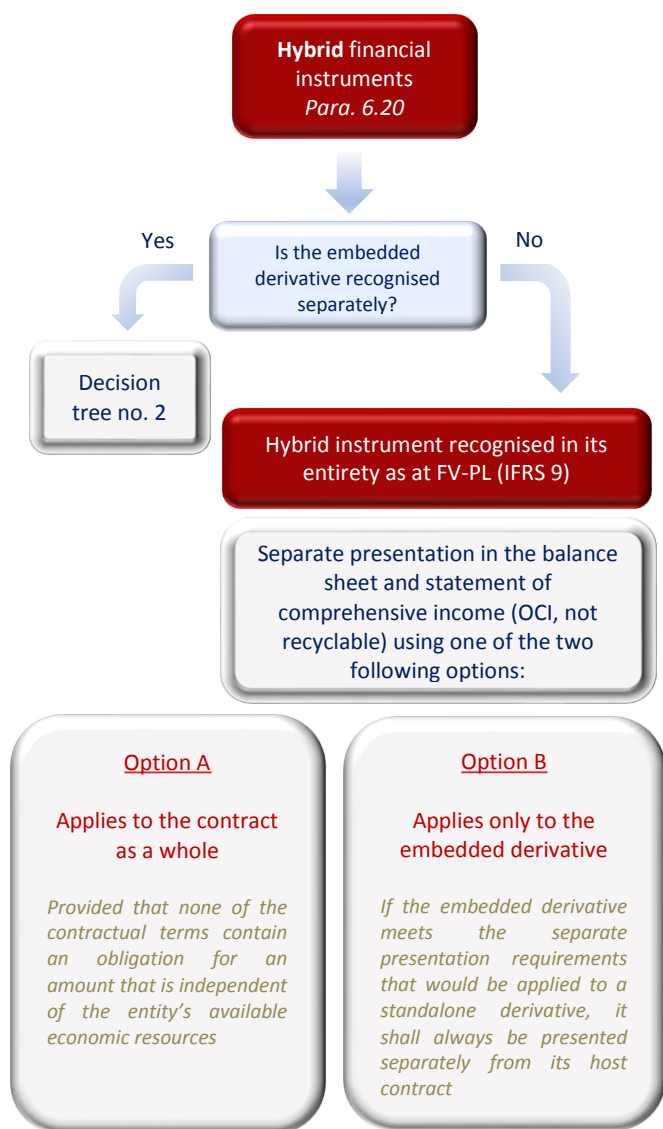
The Board has proposed, and is seeking feedback on, two presentation options (question 7):

- **Option A:** embedded derivatives that are not separated from the host contract would be exempt from the separate presentation requirements. However, hybrid instruments which, as a whole, contain no obligation for an amount that is independent of the entity's economic resources would be presented separately (e.g. shares redeemable at fair value).

- **Option B:** the same separate presentation requirements would be applied to all derivatives, irrespective of whether they are standalone derivatives, embedded derivatives that are separated from the host contract under IFRS 9, or embedded derivatives that are not separated from the host contract under IFRS 9. Under this option, entities that had opted to recognise their hybrid instruments in their entirety as at fair value through profit or loss would nonetheless have to present and measure embedded derivatives on own equity separately from their host contracts in order to meet the presentation requirements.

Decision tree no. 3: Hybrid instruments

This only relates to financial liabilities



6. Classification principles for compound instruments and redemption obligation arrangements

Definition of the scope

The principles described below apply to:

- compound instruments, i.e. instruments that include both an equity component and a financial liability or financial asset component;
- standalone derivatives that create an obligation to extinguish an equity instrument. The latter are analysed in conjunction with the equity instrument to be extinguished, creating a *redemption obligation arrangement*. An example would be ordinary shares and a written put option on ordinary shares [DP para. 5.11].

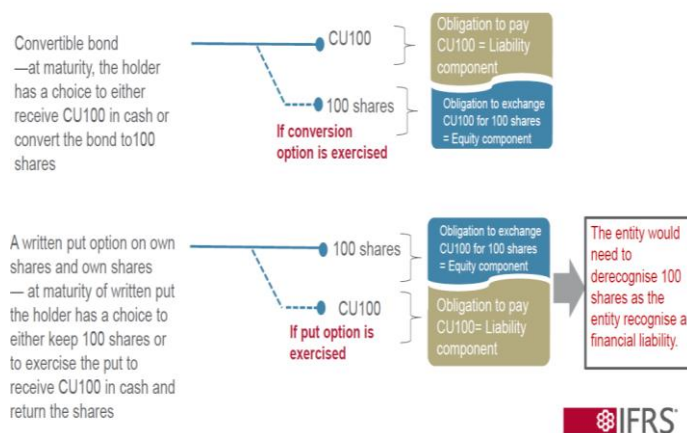
The concept of Redemption obligation arrangements

The Board's objective in defining *redemption obligation arrangements* is to ensure that the same accounting treatment is used for all transactions that result in the same type of rights and obligations for the entity, even if the contractual forms of the transactions are different.

In one of the IASB's webcasts, the Board makes a comparison between a bond convertible to own shares, and a *redemption obligation arrangement* composed of a written put option on own equity instruments and its underlying.

The IASB argues that the entity's rights and obligations are the same in both situations:

- in both cases the entity is required to pay 100 in cash (if the put option is exercised, or if the conversion option is not exercised);
- in both cases the existence of own shares at maturity depends on a third party. (equity component).



Extract from webcast no.4 on the classification of compound instruments.

Thus, standalone derivatives that are settled by extinguishing own equity instruments shall always be analysed in conjunction with the underlying equity instrument. The same analysis is used for a *redemption obligation arrangement* as for a compound instrument.

Main classification principles

The key principle, carried over from IAS 32, is that each component of the instrument must be accounted for separately. Thus, the approach proposed in the DP differs according to whether or not the compound instrument includes derivative components.

▪ **Compound instruments with non-derivative components:**

An example is a liability with a requirement to repay the principal, but discretionary coupon payments. Under the proposed approach, the first step would be to identify and measure the financial liability component according to the principles applicable to non-derivative instruments. The residual amount (i.e. the difference between the financial liability component and the transaction price) would then be allocated to the equity component [DP para. 3.27].

▪ **Other compound instruments and redemption obligation arrangements:**

Under the proposed approach, the first step would be to identify the unavoidable obligation that would require the entity to recognise a financial liability component using the analysis criteria applicable to non-derivative instruments. The next step would be to classify the remaining rights and obligations as either an equity instrument or a derivative, according to the principles applicable to derivatives on own equity.

If an entity has an unconditional right to avoid all settlement outcomes that have the characteristics of a liability, there is no liability component to be recognised [DP para. 5.48].

Applying the principles to NCI puts

Let's take the example of a written put option on non-controlling interests. We will assume that, if it is exercised, settlement will take the form of physical delivery of a fixed number of shares in exchange for a payment equal to the fair value of the shares at the point when the put is exercised. Thus, by issuing the put, the entity takes on an obligation to repurchase its own shares at their fair value in exchange for cash, at the option of the holder of the put [DP para. 1.25].

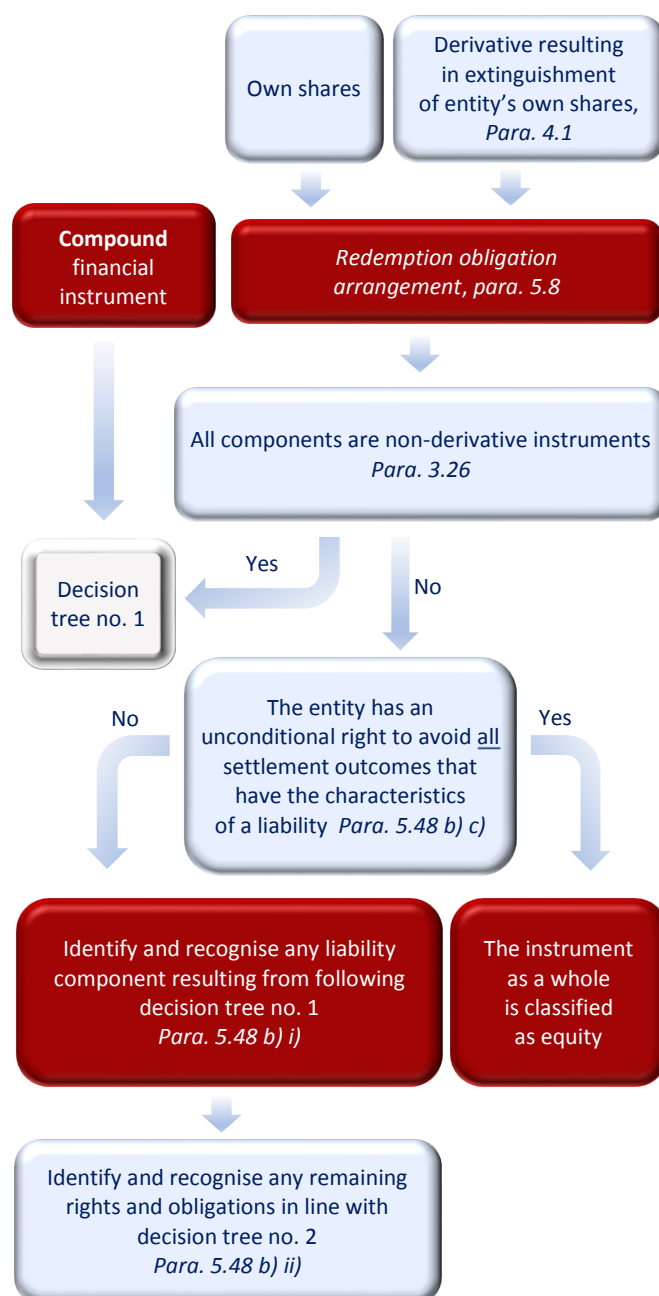
This instrument is a derivative on own equity that would be settled by the repurchase and thus extinguishment of an equity component. Consequently, under the Board's preferred approach as set out in the DP, the principles for *redemption obligation arrangements* should be applied and the instrument should be analysed in conjunction with the underlying own shares.

First, the entity recognises a liability for the fair value of the shares. It cannot avoid the obligation to pay out this amount if the holder of the put decides to exercise the option. However, this liability relates to an amount that is dependent on the available economic resources of the entity. As a consequence, it will be classified separately within financial liabilities and subsequent changes in value

will be recognised in other comprehensive income (OCI), without recycling to profit or loss. The contra entry for this liability will be an immediate reduction in the NCI component of equity.

Once this entry has been made, the entity must consider whether there are any remaining rights and obligations to be recognised. The initial accounting entry has extinguished the shares and recorded the obligation to make a cash payment if the holder exercises the put option. In order to reflect the full economic reality of the transaction, the entity must record a written call option on the same shares at a strike price equal to the fair value of the shares. This derivative represents the possibility that the put will not be exercised and the shares will not be extinguished. However, as the call has a value approaching zero at any date (its strike price is equal to the market price), no specific entry is made.

Decision tree no. 4: Compound instruments



7. Additional considerations relating to presentation and disclosures

In addition to all the issues reviewed above, the Board is also seeking to address requests for additional information from some users of financial statements.

Improving information on attribution to different types of equity instruments

Based on feedback from users of financial statements, the Board has concluded that more information is required on the attribution of equity and total comprehensive income to different types of equity instruments. The objective is to allocate the total amount of equity and the total comprehensive income for the period to the various categories of equity instruments, with the residual amount attributed to ordinary shares. This allocation would be presented directly in the statement of changes in equity.

For non-derivative equity instruments, other than ordinary shares, the total comprehensive income would be attributed according to the principles set out in IAS 33 – *Earnings per share*.

However, the principles set out in IAS 33 do not result in relevant information on derivative instruments (for example, only dilutive effects are taken into account). The Board has not yet identified a preferred approach to addressing this problem, but has proposed various options:

- the *full fair value approach*, which involves attributing performance to derivatives based on changes in their fair value;
- the *average-of-period approach*, which attributes total comprehensive income for the period to derivative instruments based on their relative average fair values through the period;
- the *end-of-period approach*, which attributes the total amount of equity based on relative fair values at the end of the period.

The Board is aware of the potential complexity and/or cost of implementing these approaches, so is also considering the option of addressing users' information requirements through additional disclosures in the notes.

In the DP, the Board presents the advantages and disadvantages of each approach and requests feedback from users to inform its future deliberations.

Information on equity instruments with various possible settlement outcomes

Some instruments are classified as equity under the DP's preferred approach, but nonetheless have various possible settlement outcomes. For example, a reverse convertible bond for which the issuer has the option to settle in own shares may be classified as equity, even if the entity may also elect to settle in cash.

The Board is considering whether it is necessary to provide additional information on this type of alternative settlement outcome that is not reflected in the instrument's classification as equity. It has identified two options:

- recognise an embedded derivative separately from its equity host instrument, thus potentially separating out a derivative asset;
- provide more information through presentation and disclosures.

The Board has not yet defined a preferred approach, and will consider the matter further in the light of comments received.

Additional disclosures that may be required

The Board is also considering what disclosures are required in the notes in order to better meet the needs of users of financial statements. It is looking at three main areas:

- disclosures on subordination (payment priority in the event of liquidation). This information could be provided either on the face of the balance sheet, or in the notes;
- disclosures in the notes on potential dilution of ordinary shares, notably all the potential sources of dilution (in addition to the requirements of IAS 33);
- disclosures in the notes on the terms and conditions of equity instruments and financial liabilities.

Key points to remember

- The Board's preferred approach is primarily based around two features:
 - the *timing feature*: there is an unavoidable obligation to transfer economic resources (cash or another financial asset) at a specified time other than at liquidation;
 - the *amount feature*: there is an unavoidable obligation to transfer an amount independent of the entity's available economic resources.
- Instruments may only be classified as equity instruments if they possess neither of these features. Otherwise, they are classified as financial liabilities. For derivative instruments, the "amount feature" is articulated around their net amount not being affected by independent variables.
- There are specific provisions for derivatives that may lead to the extinguishment of equity instruments.
- Classification outcomes may change for some instruments such as perpetual subordinated notes or derivatives on own equity with net share settlement, but the approach proposed by the Board in this DP aims at being broadly consistent with IAS 32 as regards classification in the balance sheet. Nonetheless, material impacts might occur in individual cases.
- The Board's proposed accounting treatment for puts on non-controlling interests (a topic which has already been heavily debated in the past) is likely to attract a high number of comments.
- The most innovative aspects of the DP relate to the presentation of performance (in OCI without recycling to profit or loss), the attribution of performance to equity holders, and the disclosure of additional information in the notes. It is important to get the right balance here between usefulness and relevance to users of financial statements on the one hand, and complexity/cost of implementation for preparers on the other.
- This document is a Discussion Paper, which is the stage prior to a possible exposure draft. The comments received by the IASB will help the Board decide how to proceed with this project. Comment letters should be sent to the IASB by 7 January 2019.

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Events and FAQ

Frequently asked questions

IFRS

- The accounting treatment of sale and leaseback transactions
- Discounting an earnout
- Sale of loan receivables relating to employers' participation in the construction effort
- Impairment testing for assets of an equity-accounted investment
- Group of assets held for sale
- Agent/principal distinction
- Accounting for a transactional indemnity following the purchase of a subsidiary involving an earnout

IFRS		EFRAG	
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22-26 October	27-28 November	18 October	29 November
12-16 November	16 January	22 November	20 December
10-14 December	5-6 March	18-19 December	19-20 December

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