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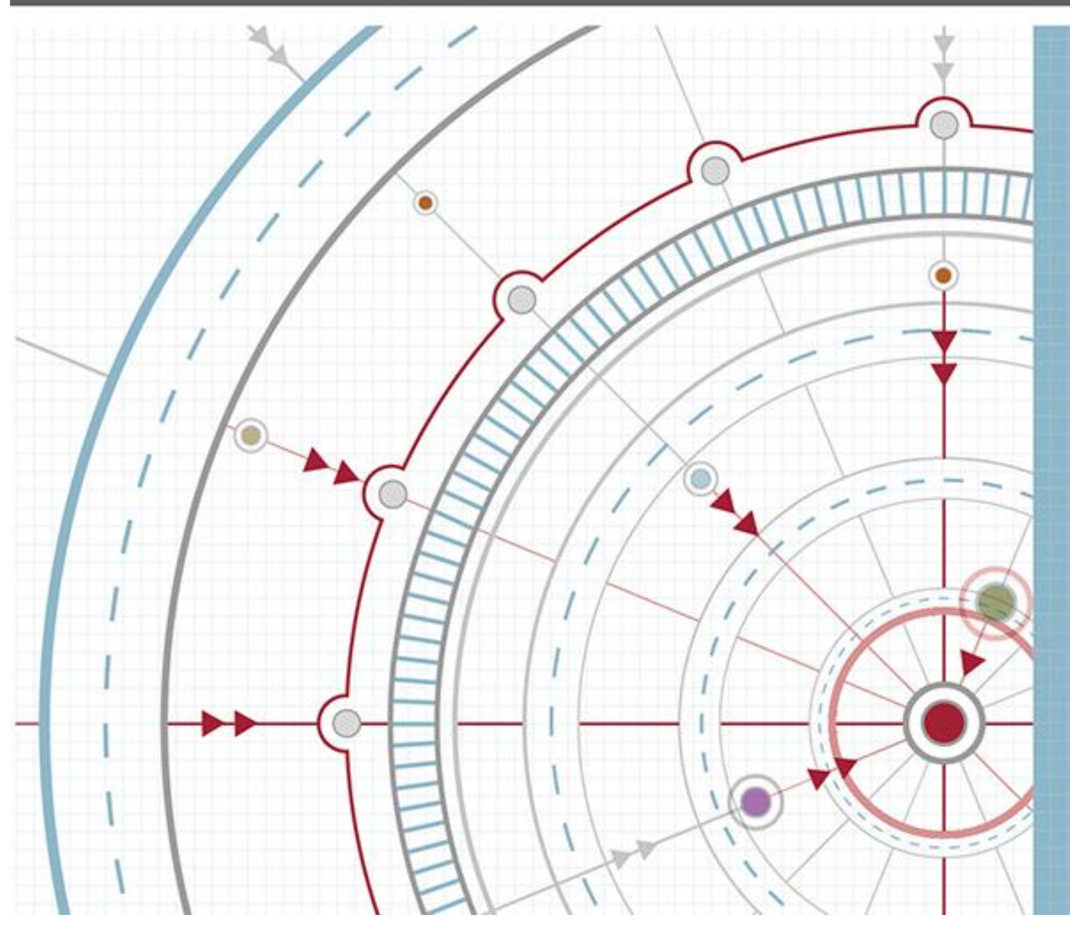

IASB Update

QCA Financial Reporting Expert Group

18 June 2019

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Agenda

- IASB Work plan
  - Status of projects
  - Highlights of current major projects
  - Deeper dive – PFS and goodwill
- Disclosure Initiative: Targeted Standards-level Review of Disclosures
- Financial Instruments with Characteristics of Equity
- Closing comments

IASB Work plan

Nili Shah,
Executive Technical Director

Status of projects

IFRS Amendments expected 2019

The Board expects to issue the following IFRS amendments in 2019:

Classification of Liabilities as Current or Non-current

Interest Rate Benchmark Reform

Current major projects—expected issuance dates

Year	Project
2019	Primary Financial Statements (ED)
	Rate Regulated Activities
	Goodwill and Impairment (DP)
	Dynamic Risk Management (Core model)
	2019 Comprehensive Review of the IFRS for SMEs Standard (RFI)
2020	Business Combinations under Common Control (DP)
	DI: Targeted Standards-level Review (ED)
	Management Commentary (ED)

Maintenance projects—Exposure Drafts expected to be issued

2019	
	Annual Improvements (2018-2020) — out for comments
	Updating a Reference to the Conceptual Framework — out for comments
	Amendments to IFRS 17 *Insurance Contracts*
	Deferred Tax Related to Assets and Liabilities from a Single Transaction
	Disclosure Initiative—Accounting Policies

Work in progress 2019

Board considering feedback on Exposure Drafts	Research in progress
Accounting Policies and Accounting Estimates	Pension Benefits that Depend on Asset Returns
Accounting Policy Changes	Provisions
Property, Plant and Equipment: Proceeds before Intended Use	Extractive activities
Onerous Contracts—Cost of Fulfilling a Contract	Subsidiaries that are SMEs

PIR on IFRS 10, 11,12 (*starting in Q3*)

Highlights of current major projects

Better Communication in Financial Reporting

Problem

- Statement of financial performance and related disclosures not sufficiently comparable and transparent
- Financial reports communicate ineffectively, provide too much irrelevant information and not enough relevant information
- Increasing need for additional information on intangibles, ESG, matters that underpin long-term success and linkage to strategy
- Financial reports increasingly being consumed electronically

Approach

	Financial statements		Outside financial statements
Content	Primary Financial Statements*	Disclosure Initiative*	Management Commentary
Delivery	IFRS Taxonomy		

* To be discussed in meeting – see PFS slides (22-27) and DI slides (32-57)

Better Communication in Financial Reporting
What is management commentary?

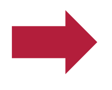
- A narrative report that gives context for the financial statements and additional insight into the company's long-term prospects
- Sits within the boundaries of financial reporting and is aimed at primary users of financial reports—existing and potential investors, lenders and other creditors

Environmental, social and governance (ESG) matters—normally part of wider corporate reporting—are discussed in management commentary if necessary for primary users to make economic decisions

Better Communication in Financial Reporting Management Commentary - project focus

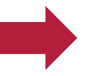
Why revise?

Developments in narrative reporting



Gaps in current reporting practice

Increasing need for additional information



Focus of revision

Meet primary users' information needs

Retain a principles-based approach but expand the guidance to:

- consolidate innovations
- address gaps in reporting
- support rigorous application

Particular emphasis on:

- company-specific matters
- intangibles and ESG matters
- matters that underpin long-term success
- coherent discussion linked to strategy

Intended to be compatible with jurisdictional requirements and subject-matter frameworks (eg TCFD, SASB)

Business Combinations under Common Control

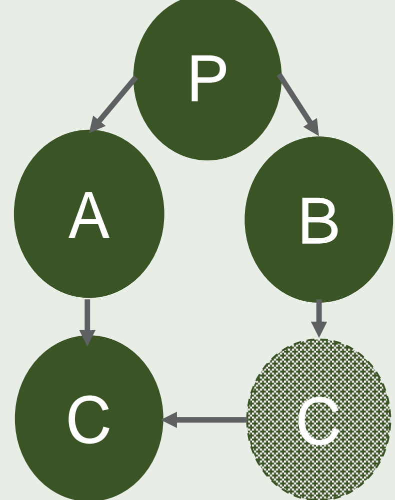
Problem

Absence of IFRS requirements reduces comparability and understandability of financial information

Approach

Address accounting by the **acquiring entity** in the combination

Entity A acquires Entity C



Consider whether and how BCUCC transactions can be different from business combinations defined in IFRS 3 *Business Combinations*

Focus on information needs of primary users and costs of providing and using information in determining whether a current value approach or a predecessor approach should be applied in various scenarios

Business Combinations under Common Control

Board's Tentative Decisions

Start with the acquisition method in IFRS 3 for transactions that affect **non-controlling shareholders** and consider whether to modify it

Need not necessarily pursue a single approach for transactions that affect non-controlling shareholders and transactions between wholly owned entities

Specifically, the Board could pursue a current value approach for all or some transactions that affect non-controlling shareholders and a predecessor approach for transactions between wholly owned entities

Next steps

Explore information needs of potential equity investors

Consider when a current value approach and a predecessor approach should be applied to BCUCC

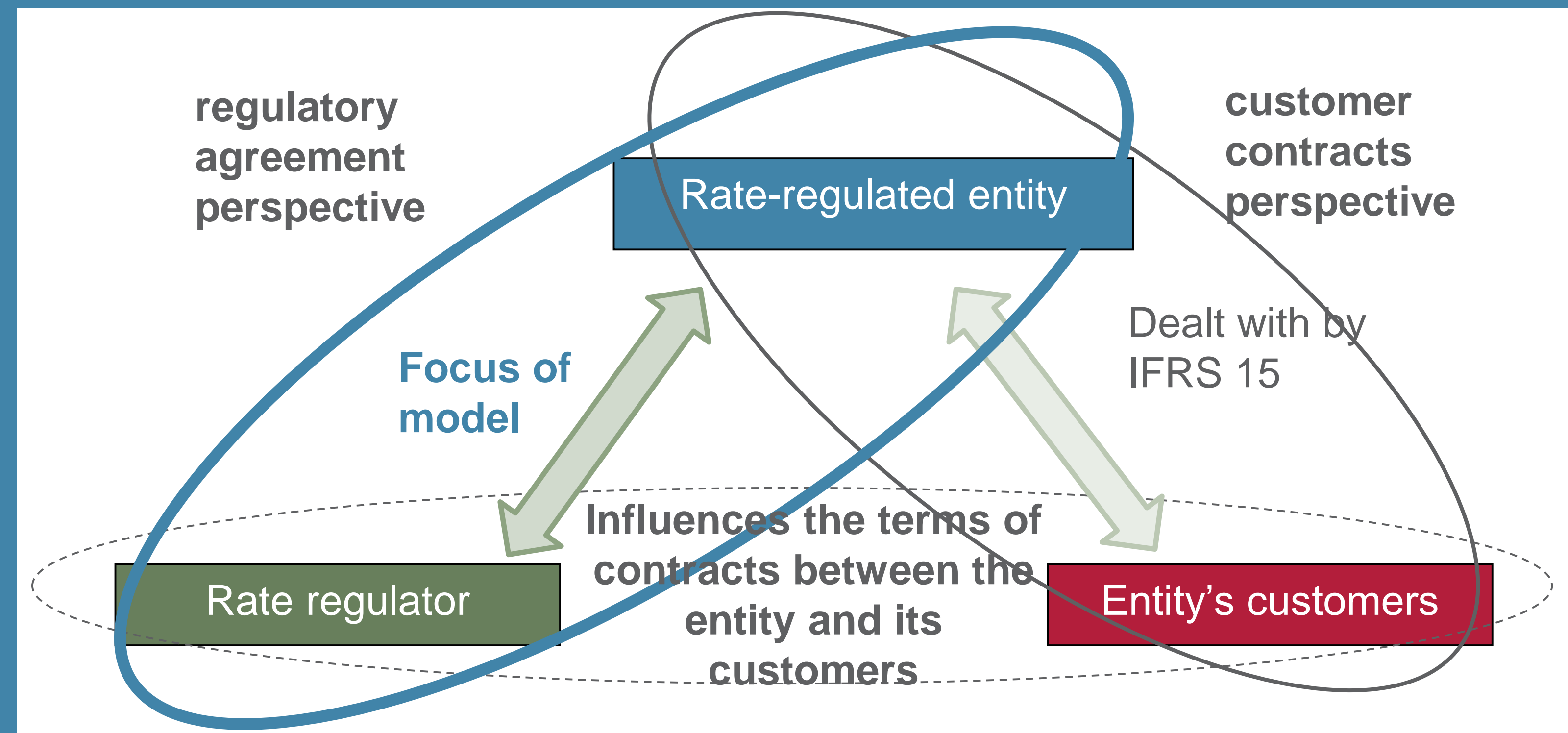
Plan to issue a Discussion Paper in the first half of 2020

Rate-regulated Activities

Problem

Binding rate regulation agreements can give rise to rights and obligations incremental to those recognised in applying IFRS 15 *Revenue from Contracts with Customers*

Not recognising these incremental rights and obligations gives investors incomplete information about a rate-regulated entity's financial position and financial performance



Rate-regulated Activities

Approach Developing an accounting model that recognises the incremental rights and obligations as assets (regulatory assets) and liabilities (regulatory liabilities)

Board's Tentative Decisions

An entity should:

- Recognise regulatory assets and regulatory liabilities
- Measure using a cash-flow based technique
- Present:
  - regulatory assets and regulatory liabilities
  - net movement between the opening and closing carrying amounts of regulatory assets and regulatory liabilities—immediately below the revenue line item

Next steps Plan to issue an Exposure Draft or a Discussion Paper by the end of 2019

Dynamic Risk Management

Problem

An entity manages interest rate risk positions that change frequently with open portfolio of changing financial assets and financial liabilities

Approach

Develop an accounting model that enables financial statements to:

- reflect management's dynamic interest rate risk management activities; and
- enable investors to evaluate effectiveness of those activities

Dynamic Risk Management (continued)

Board's Tentative Decisions

Develop a **core model** to be tested before addressing detailed areas

Core model components:

- identify eligible financial assets
- define 'target profile' (eg want to achieve 3 year floating rate profile)
- define derivatives included in model
- set out how to reflect performance

Next steps

Plan to test core model H2 2019

IBOR Reform and the Effects on Financial Reporting

Problem

The potential discontinuation of interest rate benchmarks (ie IBOR reform) could have a significant and widespread impact across financial markets and could potentially reduce usefulness of information for investors

Approach

Phase 1 – Assess the nature and extent of the issues affecting financial reporting before IBOR reform is enacted

Phase 2 – A later phase will consider issues arising when IBOR reform is enacted

IBOR Reform and the Effects on Financial Reporting (continued)

Board's Tentative Decisions

Phase I

Address concerns related to the uncertainties arising from IBOR reform by **assuming cashflows unaffected** by the reform when applying the following hedge accounting requirements in IFRS 9 and IAS 39:

- highly probable
- prospective assessment
- separately identifiable risk components

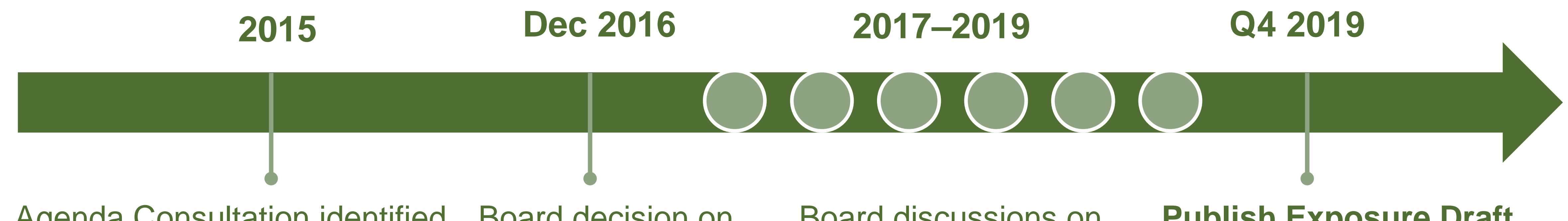
That relief does not affect the actual economics of the transactions which will continue to be reflected in financial reporting

Next steps

Out for comment - Exposure Draft issued May 2019

Deeper dive – PFS and goodwill

Primary Financial Statements project



2015	Dec 2016	2017–2019	Q4 2019
Agenda Consultation identified the project as a priority	Board decision on project scope	Board discussions on topics in project scope	**Publish Exposure Draft for public comment**

objective

Targeted improvements to the primary financial statements with a focus on the statement(s) of financial performance

out of scope

- Fundamental revision of the statements of financial position, cash flows and changes in equity
- Guidance on content of OCI and timing of recycling
- Segment reporting
- Presentation of discontinued operations

Main issues the Board is addressing in the project

Statements of financial performance are not sufficiently comparable between different companies

Introduce **required and defined subtotals** in the statement(s) of financial performance

Non-GAAP measures can provide useful information, but transparency and discipline need to be improved

Introduce disclosure of **Management Performance Measures (MPMs)**

Level of disaggregation does not always provide the information I need

Introduce **requirements to improve disaggregation**

Introducing required and defined subtotals in P&L

(example for general corporates, analysis of expenses by nature)

	Revenue	16,500
	Changes in inventories of finished goods and work in progress	(1,000)
	Raw material and consumables used	(6,000)
	Employee benefits expense	(4,000)
	Amortisation expense	(800)
	Depreciation expense	(1,200)
	Impairment of property, plant and equipment	(500)
1	**Operating profit**	**3,000**
	Share of profit of **integral** associates and JVs	500
2	**Operating profit and share of profit or loss of integral associates and JVs**	**3,500**
	Changes in the fair value of financial assets	250
	Dividend income	50
	Share of profit of **non-integral** associates and JVs	100
3	**Profit before financing and income tax**	**3,900**
	Interest income from cash and cash equivalents	100
	Expenses from financing activities	(1000)
	Unwinding of discount on pension liabilities and provisions	(100)
	Profit before tax	2,900

Operating

Investing

Financing

Management performance measures (MPMs)

Disclosure in the notes of measures of profit not defined by IFRS Standards

In management's view **complements** IFRS-defined totals or subtotals in communicating an entity's performance

Same measure must be used in public communications with users **outside financial statements**

Must **faithfully represent** the financial performance of the entity to the users

Accompanied by disclosures to **enhance transparency,** in a **single note** —including a **reconciliation** to the closest IFRS-defined total or subtotal (see example on next slide)

Example of MPM reconciliation

The MPM is disclosed in a **separate reconciliation** in the **notes**:

Adjusted operating profit (MPM)	4,400	Tax	NCI
Restructuring expenses for the closure of Factory A	(1,000)	200	50
Impairment of asset B	(400)	80	-
Operating profit (IFRS-specified)	3,000		

Most directly comparable subtotal/total specified by IFRS Standards—can be:

- any of the subtotals required by para. 81A of IAS 1;
- any of the three subtotals proposed in this project;
- profit before tax, profit from continuing operations or gross profit; or
- operating profit before depreciation and amortisation—this means entities are unlikely to be required to disclose tax and NCI for depreciation and amortisation.

Disaggregation

General	Improved principles, definitions and guidance on aggregation and disaggregation (eg on 'other' balances)
Expense analysis	• Entities are required to present their primary analysis of operating expenses by nature **or** by function in the statement(s) of financial performance. • When primary analysis of expenses is presented by function, entities are required to disclose a **full analysis of expenses by nature in the notes**.
Unusual items	• **Definition of unusual items**: 'income or expenses with limited predictive value because it is reasonable to expect that similar items will not arise for several future annual reporting periods. Similar items are income or expenses that are similar in type and amount.' • Requirement for all entities to provide a note disclosing **unusual items**, **attributed to line items** in the statement(s) of financial performance.

Goodwill and Impairment

Problems

Post-implementation review of IFRS 3:

1. Impairment test costly
2. Impairments not timely
3. Users need information to assess subsequent performance of acquisitions

1 Impairment test costly

Simplify impairment test process:

- permit relief from mandatory annual quantitative test?
- allow restructuring/enhancement cash flows in value in use estimates?
- allow post-tax inputs in value in use estimates?

2 Impairments not timely

- Reintroduce amortisation of goodwill?
- Separate line item or sub-total to highlight carrying amount of acquired goodwill?

3 Information on subsequent performance

Improve disclosures to explain:

- strategic rationale and key objectives for acquisition (replacing primary reasons)
- post-acquisition performance – are key objectives being achieved?

Next steps

- Board to decide on preliminary views in June Board meeting
- Publish Discussion Paper late 2019

Adding disclosure requirements on subsequent performance

Initial disclosure

- strategic rationale for business combination, how the acquisition links to the acquirer's business strategy
- key objectives of business combination, targets management expects to achieve
- measures management plans to use, in internal reporting, to assess extent key objectives of business combination being achieved

Subsequent performance

- amounts of those measures being used to monitor business combination
- if not being monitored, reasons
- reasons for changing the measures used to monitor business combination

Subsequent performance—discussion

Why is information needed?

- Stewardship
- Valuation purposes
- Segment information alone insufficient

What measures should be disclosed?

- Diversity of business combinations
  - No single measure
  - Operational or financial measures
- Management approach
  - Internal information more robust and cheaper
  - Insight into management assessments
- Minimum measures?
- If management does not monitor
- If measures used change

How long should information be provided?

- General support for – short timeframe
- Suggest year of acquisition and two subsequent annual reporting periods
- More if management continues to review

For all material business combinations?

- What do ‘management’ and ‘monitor’ mean?
- Onerous disclosure for serial acquirers?
- Set a higher threshold, eg chief operating decision maker (IFRS 8 *Operating Segments*)?

Barriers?

- Integration
- Commercial sensitivity
- Forward-looking information

Targeted improvements to existing requirements

Existing requirements	Feedback	Possible improvement
Qualitative factors making up goodwill, eg expected synergies	• Generic and boilerplate information • Users want quantitative information on expected synergies	Requiring an acquirer to disclose: • Description of synergies and expected timing • (Range of) amounts of synergies • (Range of) expected costs to achieve synergies
Major class of assets acquired and liabilities assumed	• Debt and defined benefit pension obligations not separately disclosed	• Disclosure of liabilities arising from financing activities and defined benefit pensions obligations as major classes of liabilities
Acquiree's revenue and profit or loss and pro forma information	• 'Profit or loss' not defined • Little guidance on pro forma preparation • Users need information to predict performance and provide comparability	• Disclosure of acquiree's revenue, operating profit or loss and cash flow from operating activities, since acquisition date • Removing requirement for pro forma information

Removal of some existing disclosure requirements in IFRS 3 also being considered

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Disclosure Initiative: Targeted Standards-level Review of Disclosures

Kathryn Donkersley
Technical Staff

This session

- We will summarise the Board's Targeted Standards-level Review of Disclosures project, including:
  - feedback from users of financial statements about the disclosure requirements of IAS 19 *Employee Benefits* and IFRS 13 *Fair Value Measurement*
  - user information objectives for those Standards, and examples of information that might meet those objectives
- We will ask you to share your thoughts on the feedback from users, and on the potential costs of preparation of the IAS 19 and IFRS 13 information summarised in these slides

Background

Disclosure Initiative—the disclosure problem

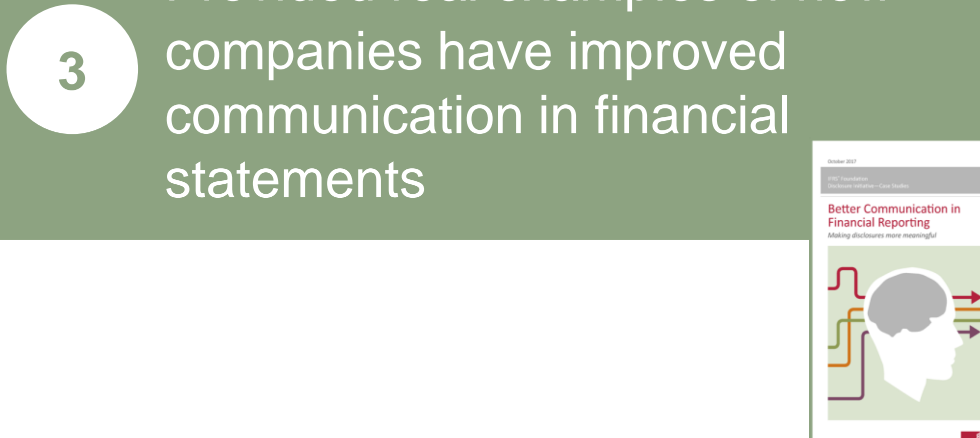
- The Board has identified three main concerns about disclosures in financial statements:
  - not enough relevant information
  - too much irrelevant information
  - ineffective communication

What has the Board already done?

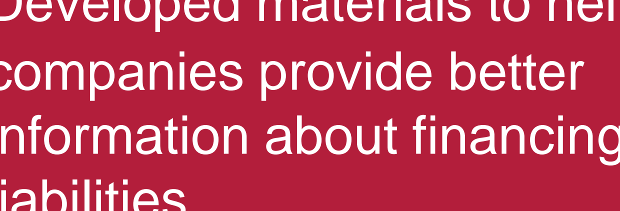
1 Removed barriers to the application of judgement

2 Provided tools to help companies make more effective materiality judgements

3 Provided real examples of how companies have improved communication in financial statements



4 Developed materials to help companies provide better information about financing liabilities



What has the Board already done?

Researched what will be **most effective** in helping to address the disclosure problem

March 2019

IFRS® Standards
Project Summary

Disclosure Initiative—Principles of Disclosure

Project summary published March 2019

http://go.ifrs.org/di-principles-of-disclosure-project-summary

Active projects

Key stakeholder feedback

The disclosure requirements in IFRS Standards contribute to the disclosure problem

Standards-level activity would be most effective

Accounting policy disclosures often do not provide the information investors want

Board response

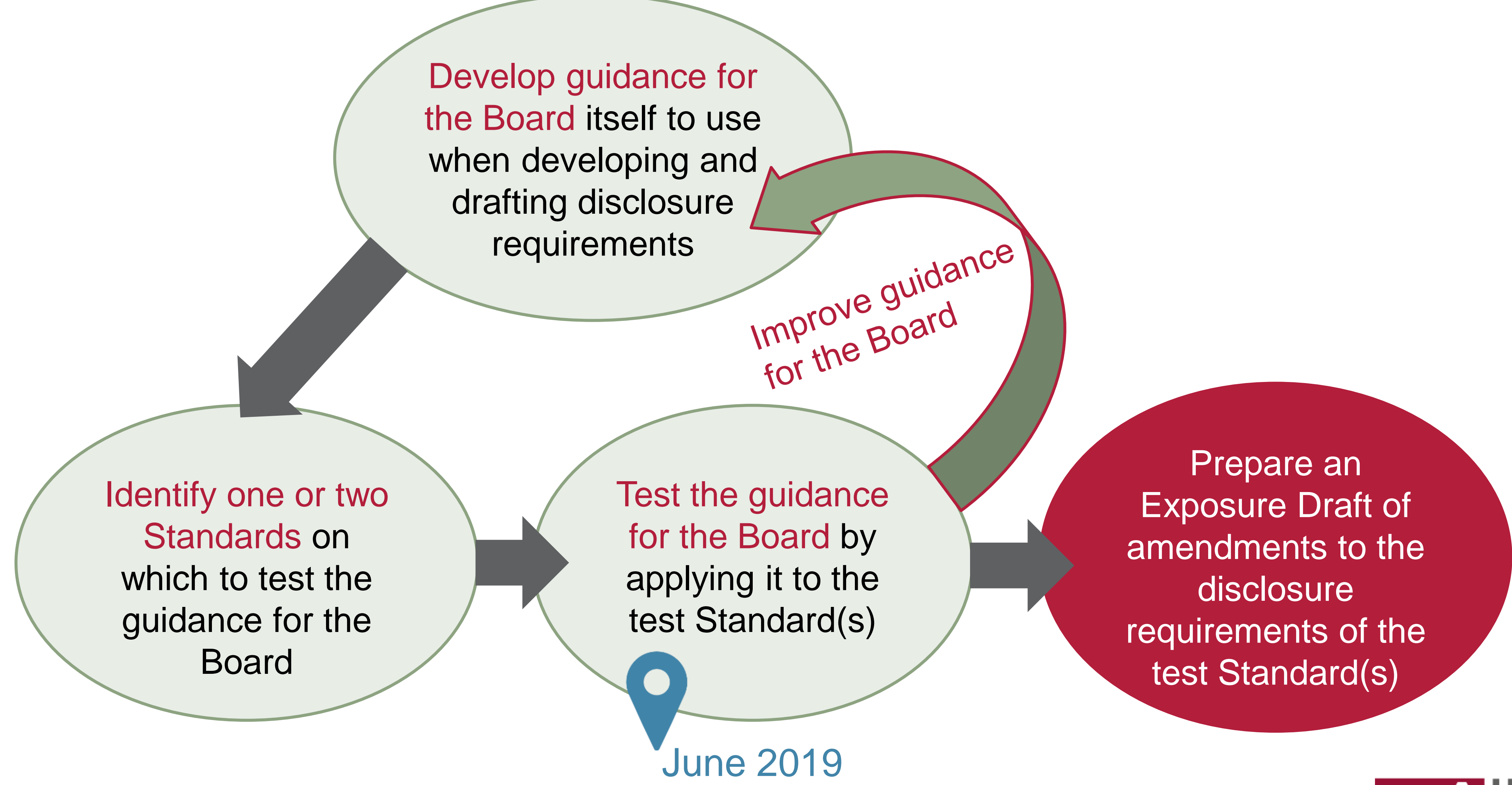
Prioritise Targeted Standards-level Review of Disclosures project

Add project on Disclosure of Accounting Policies to the Board's agenda

Board expects to publish an Exposure Draft of Amendments to IAS 1 and the Materiality Practice Statement in August 2019

Targeted Standards-level Review of Disclosures

Targeted Standards-level Review of Disclosures



Guidance for the Board

Some of the things the Board is thinking about….

Why information is useful

What investors will do with the information

Specific disclosure **objectives**

Costs and other consequences

Drafting **language**

Electronic reporting

Test Standards

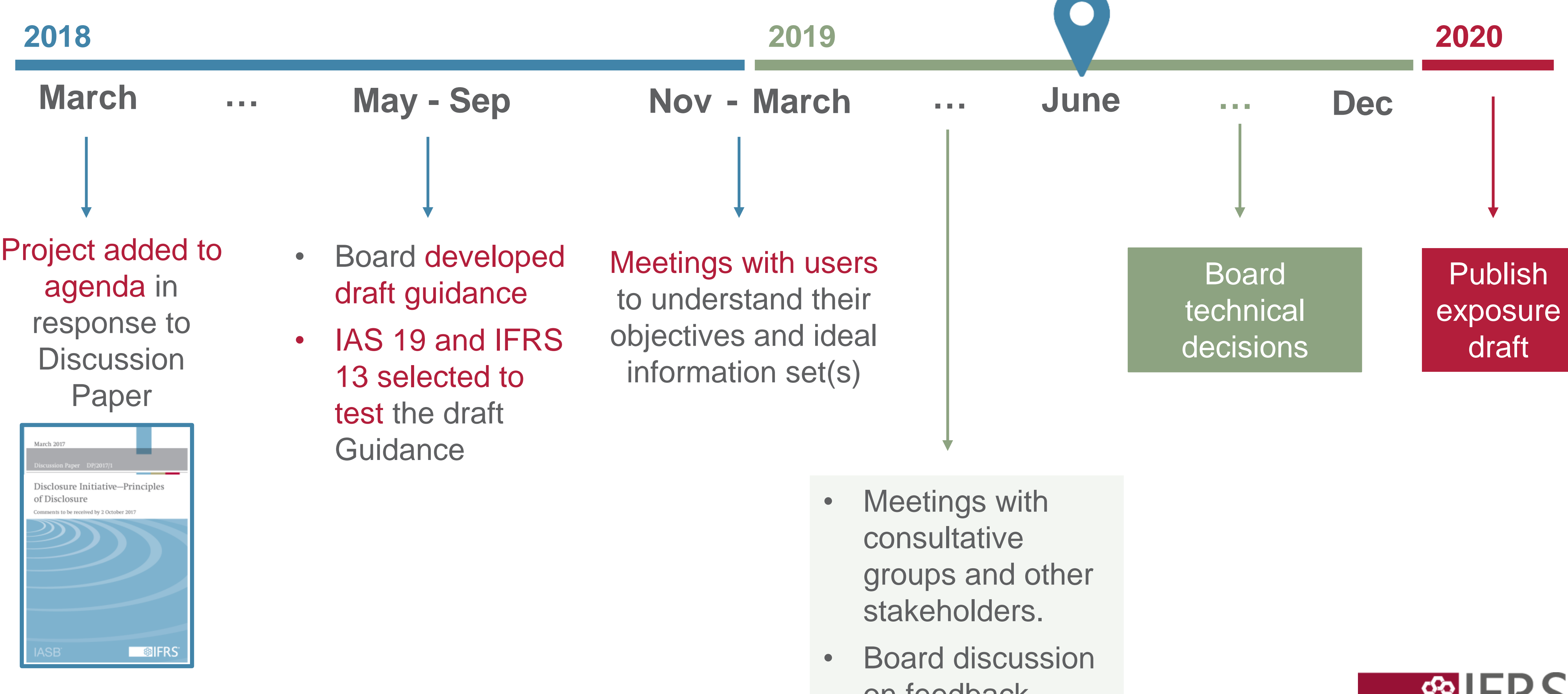
IAS 19
Employee Benefits

IFRS 13
Fair Value Measurement

Stakeholders provided feedback that these Standards contain:

1. Lack of, or insufficient disclosure objectives
2. Disclosure requirements that are:
   - Duplicative
   - Lengthy
   - Incomplete
   - Not useful
   - Costly to produce
   - Difficult to understand
   - Overly prescriptive
3. Disclosure requirements that often result in insufficient or boilerplate information

Targeted Standards-level Review of Disclosures: Project timeline



IAS 19
Employee Benefits

Feedback so far on employee benefits…

- Almost all users said they primarily focus on disclosures relating to defined benefit plans.
- Most users say today's pension disclosures based on IAS 19 are often not effective in meeting their primary objectives.
- Information users would like to see includes:
  - information about the expected cash flow effects of the pension plan
  - better explanation and disaggregation of the amounts recognised in the primary financial statements
- Preparers say many of today's required disclosures are onerous to prepare. For example, sensitivity analysis of significant actuarial assumptions. Preparers understand the user need for improved information about cash and would support relevant disclosure.

User objectives for IAS 19 disclosures

Objectives
A. Forecast future pension obligations
B. Determine the *real* value of the pension obligation to input into analyses for forecasting, such as enterprise value calculations.
C. Evaluate the impact of the pension obligation on the entity's cash flows.
D. Assess the appropriateness of the assumptions and amounts underlying the entity's valuation of its pension obligation.
E. Understand the economics of the plan(s) held and specifically, the risks to which the plan(s) expose the entity. This also allows users to assess any potential future exposures.
F. Understand the sensitivity of the pension obligation to different assumptions to determine appropriate risk adjustments
G. Understand the risks, and expected future cash flows, associated with *closed* defined benefit plans. This includes understanding the time period over which any remaining obligations is expected to wind down.
H. Understand the effect of an entity's plan(s) on the primary financial statements.

Information that might meet user objectives

Specific items of information
1. Explanation, and disaggregation of amount recognised in the financial statements. Disaggregation by geography, segments, member type and/or plan type.
2. Narrative information about the nature and characteristics of defined benefit plans.
3-4. Identification of the significant financial and demographic assumptions used in deriving the pension obligation. Including an explanation as to why those are the most significant.
5. ***Wider*** sensitivity analysis of the principal actuarial assumptions. The analysis also shows the effect of changing multiple assumptions simultaneously.
6. Explanation of differences between various pension plan valuations (IAS 19 valuation, funding/triennial valuation, buyout value).
7. Schedule of expected contributions into the plan(s), either as agreed with trustees/appropriate regulatory bodies or internally budgeted.
8. Fair value of the plan assets disaggregated by asset types. Including information about associated risks, hedging activities and actual rate of return on specific asset types.
9. Reconciliation between the opening and closing balances of the plan assets and pension obligation.
10. Schedule of expected future benefit payments to members of closed plans. Including the maturity analysis and information about approach to managing remaining obligations.

Some examples

- The examples on the following slides are based on real disclosures provided by companies
- They show examples of information that could be used to meet user objectives about the cash flow effect of pension schemes
- They are not Board proposals but are provided to facilitate discussion

Example: Expected contributions into the plan

User objective	• Expected contributions (as agreed with trustees or internally budgeted by management) would allow users to better evaluate the impact of the obligation on cash flows. ✓ The information is considered more useful if it differentiates between 'ordinary' (payroll deductions) contributions and other contributions to reduce existing deficit.

Example disclosure

The Group has agreed a funding plan with the Plan Trustees that addresses the funding deficit over a maximum period of 15 years. The funding deficit as at 30 June 2017 was £8.6 billion demonstrating that the market value of the plan assets are not sufficient to meet the expected future benefit payments. The deficit will be met over a period of 10 years. The deficit contributions have three components:

- payments *by the Group* over 3 years to March 2020 totalling £2,100 million. £850 million of this was paid in March 2018 and the remaining £1,250 million is to be paid by March 2020.
- a further £2,000 million is due to be contributed by March 2019 from the *proceeds of the issuance of bonds* which will be held by the Group.
- for the 7 years from April 2021 to March 2027, the Group will make annual payments of around £900 million.

The Group is scheduled to make future deficit payments to the pension scheme in line with the table below:

Year to 31 March	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Deficit Contribution (£m)	850	2,000	1,250	900	900	907	907	907	907	907

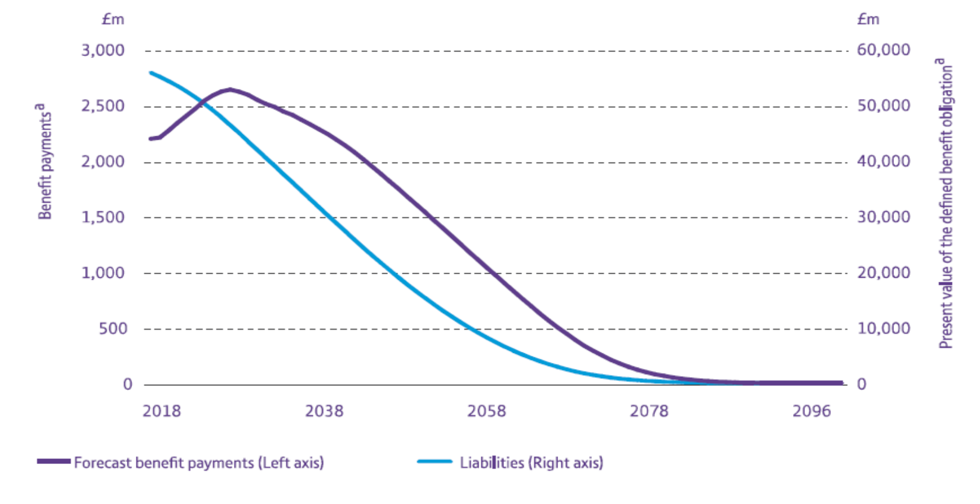
Ordinary cash contributions to the scheme of £264 million have been made in the current year, £303 million will be made in 2019 and then rising by 3% per annum to 2027.

Example: Expected future benefit payments from the plan

User objective	• Users want to understand the time period over which the remaining obligations are expected to wind down and the associated expected payments.

Example disclosure

The Group's defined benefit plans are closed to new members. The estimated duration of the pension scheme liabilities, which is an indicator of the weighted average term of the liabilities, is around 16 years although the benefits payable by the scheme are expected to be paid over more than 70 years. The chart below illustrates the estimated benefits payable from the pension scheme using the IAS 19 assumptions:



£m	Total
Plan participants (number)	293,000
Actual benefit payments 2018	2,315
Benefits expected to be paid 2019	2,320
Benefits expected to be paid 2020	2,355
Benefits expected to be paid 2021	2,378
Benefits expected to be paid 2022	2,410
Benefits expected to be paid 2023	2,437

IFRS 13
Fair Value Measurement

Feedback so far on fair value measurement…

- Most users that analyse detailed IFRS 13 disclosures are broadly happy with the information they receive today.
- Many users do not used detailed IFRS 13 disclosures in their analysis because:
  - those disclosures are rarely material to the companies they monitor; or
  - detailed disclosures are only provided for Level 3 assets, but for some companies the most significant fair value measurements are for Level 2 assets.
- Users highlighted the importance of effective application of materiality
- Preparers say many of today's required disclosures are onerous to prepare and that often users do not ask questions about their IFRS 13 disclosures.

User objectives for IFRS 13 disclosures

Objectives
A. Understand the sensitivities of the entity’s instruments measured at fair value.
B. Determine the appropriate fair value adjustments to input into analyses such as enterprise value calculations.
C. Forecast future fair value movements in order to for example, determine expected returns on assets.
D. Assess the appropriateness of the inputs, techniques and amounts underlying an entity’s fair value measurements.
E. Understand the nature and characteristics of the assets and liabilities measured at fair value, particularly for complex or hybrid instruments.

Information that might meet user objectives

Specific items of information
1. Breakdown by the type of instruments within each level of the fair value hierarchy. Including additional explanation for complex instruments.
2. Narrative information about how an entity has determined which level an instrument belongs in.
3. Identification and explanation of the inputs used in deriving the fair value measurements.
4. ***Wider*** sensitivity analysis of Level 3 fair value measurements. The analysis also shows the effect of changing multiple inputs simultaneously to reflect alternative assumptions. Provide effect(s) on profit or loss/OCI on a post-tax basis.
5. Valuation techniques and processes applied to Level 3 fair value measurements.
6. Reconciliation between opening and closing balances of Level 3 fair value measurement.
7. Additional disclosures for Level 2 fair value measurement. Including those described in **4-6** above.
8. Fair value of financial investments not held at fair value.
9. Quantitative sensitivity analysis for investment property measured at fair value.
10. Explanation and disaggregation of total fair value of assets and liabilities recognised on the balance sheet. Disaggregation by geography and instrument type.

An example

- The example on the following slides is based on real disclosure provided by companies
- It shows an example of information that might help meet user objectives about Level 2 fair value measurement disclosures. This is not a Board proposal but is provided to facilitate discussion.
- An alternative suggestion made by users is for companies to disclosure similar information for Level 2 fair value measurements as they do for Level 3 fair value measurements

Example: Explanation of how an entity has determined the level to which its assets and liabilities belong (1 of 2)

User objective	• Users want to understand how an entity has assessed the boundaries between the levels of the fair value hierarchy—i.e., which level does an instrument belong in? ✓ An entity-specific explanation is especially important for complex financial instruments or where judgment has been applied.

Example disclosure

Determination of fair value

The determination of fair value requires judgment and is based on market information, where available and appropriate. The Company classifies fair value measurements using a fair value hierarchy that reflects the significance of the inputs used in making the measurements. The fair value hierarchy has the following levels:

- Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities;
- Level 2 – Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices); and
- Level 3 – Inputs for the asset or liability that are not based on observable market data (unobservable inputs).

…continued

Example: Explanation of how an entity has determined the level to which its assets and liabilities belong (2 of 2)

…continued

Example disclosure

At the end of each reporting period, management estimates the fair value of investments based on the criteria below and reflects such valuations in the financial statements.

i. Securities including shares, options and warrants which are traded in an active market, such as on a recognized securities exchange and for which no sales restrictions apply, are presented at fair value based on quoted closing trade prices at the end of the reporting period or the closing trade price on the last day the security traded if there were no trades at the end of the reporting period. These are included in Level 1 of the fair value hierarchy (see Note 6).

ii. For options, warrants and conversion features which are not traded on a recognized securities exchange, no market value is readily available. When there are sufficient and reliable observable market inputs, a valuation technique is used. Valuation models such as the Black-Scholes valuation model ("Black-Scholes") and the Monte Carlo simulation ("Monte Carlo") are used when there are sufficient and reliable observable market inputs. These market inputs include risk-free interest rate, exercise price, market price at the date of valuation, expected dividend yield, expected life of the instrument and expected volatility of the underlying security based on historical volatility. These are included in Level 2 of the fair value hierarchy (see Note 6).

iii. Convertible debts and loans issued by investee companies are generally valued at the price at which the instrument was issued. The Company regularly considers whether any indications of deterioration in the value of the underlying business exist, which suggest that the debt instrument will not be fully recovered. The fair value of convertible debentures is measured using valuation techniques such as Black-Scholes and Monte Carlo.

   The inputs to these models are taken from observable markets where possible, but where this is not feasible, a degree of judgment and assumptions provided by management is required in establishing fair values. Judgments include consideration of inputs such as credit risk, discount rates, volatility, probability of certain triggering events, and share price of private company borrowers. Changes in assumptions relating to these factors could affect the reported fair value of the financials instruments. These are included in Level 3 of the fair value hierarchy (see Note 6).

Financial Instruments with Characteristics of Equity

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Technical Staff

What is the problem?

IAS 32 covers classification of financial instruments as liabilities or equity. It works well for most financial instruments but…

Financial innovation since IAS 32 was issued has resulted in challenges with applying it to a growing number of complex financial instruments

Some inconsistent outcomes for economically similar instruments

Limited information provided for equity instruments

Resulting in application challenges and accounting diversity in practice

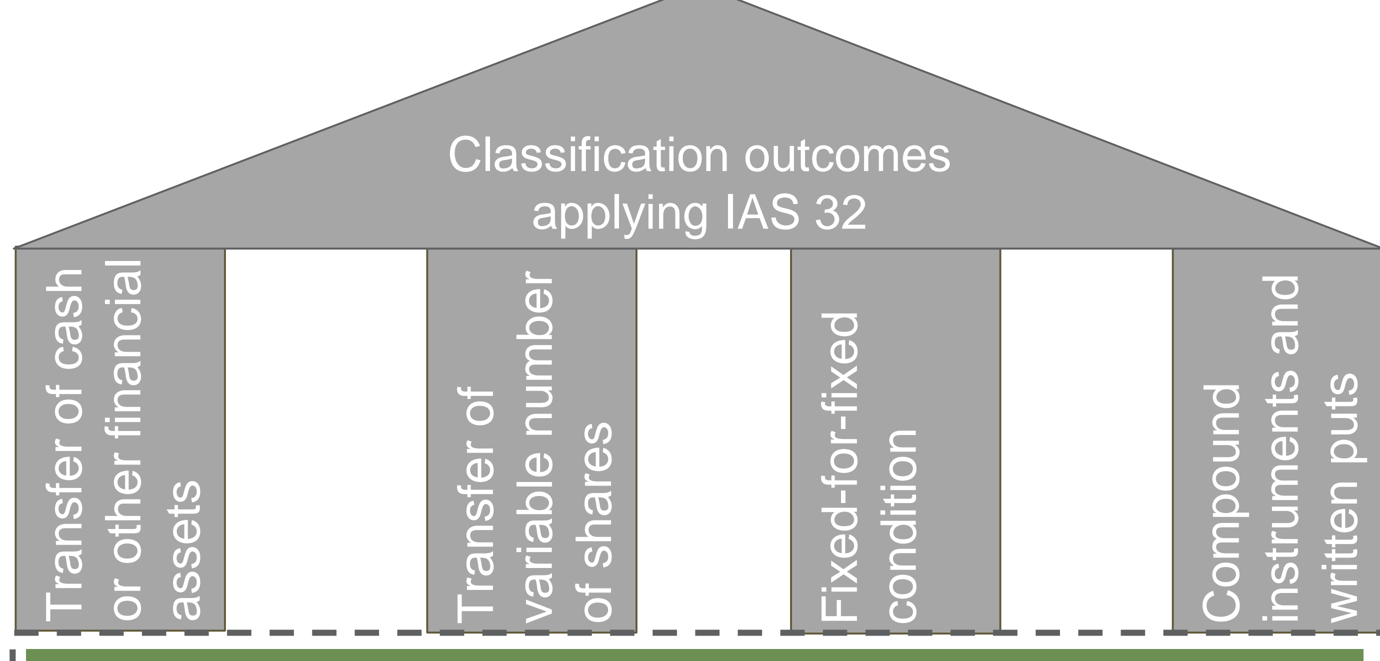
Diversity makes it difficult for investors to assess how these financial instruments affect companies' financial position and performance

DP proposals—Multi-faceted approach

- To respond to challenges identified, the Board has developed an approach that considers classification, presentation and disclosure of financial instruments issued by an entity.
- The Discussion Paper (DP) was published in June 2018 with a 180-day comment period.

Classification	• Still a single distinction (liability or equity) • Clear principles • Address accounting diversity in practice • Limit changes to classification outcomes
Presentation	• Separate presentation for liabilities with value based on 'residual' • Expanded statement of changes in equity (including attribution of performance to classes of equity)
Disclosure	• Consider investor information needs re: dilution, liquidity, solvency • Interaction with EPS?

Classification requirements of IAS 32 and DP proposals



DP proposes a classification principle based on…

Timing feature: how a financial instrument affects the entity's liquidity and cash flows

Amount feature: how a financial instrument affects the entity's solvency and returns

DP proposals—the basic idea is…

- The DP proposes a classification principle that applies to all financial instruments issued by an entity.

A financial instrument issued by an entity is a financial liability if the answer is yes to one or both of the following questions

Can the issuer be required to hand over cash or another financial asset before liquidation?

Timing feature

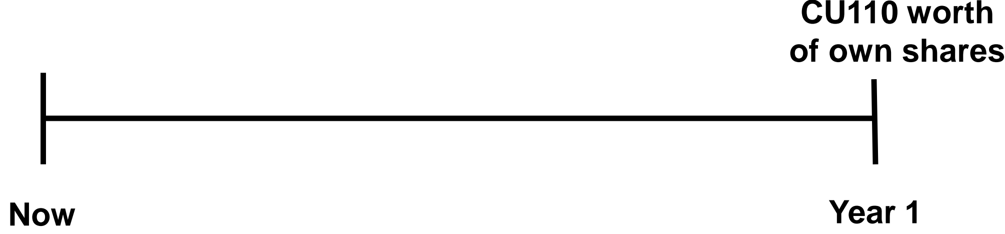
Has the issuer promised a return to the instrument's holder regardless of the issuer's own performance or share price?

Amount feature

Otherwise, it is an equity instrument

DP proposals—Example #1

- Issue an instrument for CU100
- Obligation to deliver own shares worth CU110 at year 1

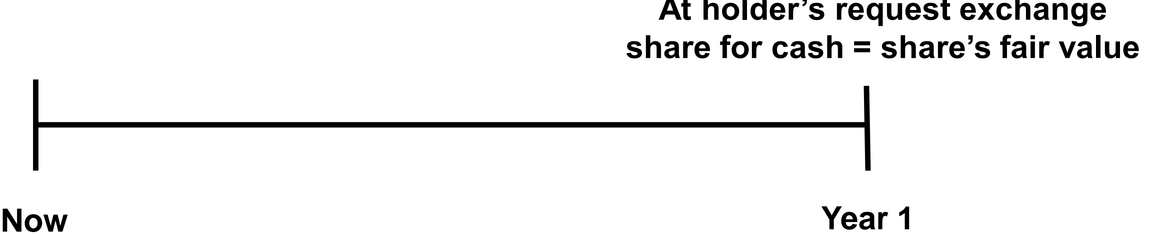


Should it be classified as liability or equity?		
Timing Feature	Any obligation to transfer cash before liquidation?	✗
Amount Feature	Return on instrument independent?	✓

Classified as a financial liability

DP proposals—Example #2

- **Issue a share with the same rights as an ordinary share BUT agree to redeem the shares in cash at the holder's option at year 1 for its fair value**

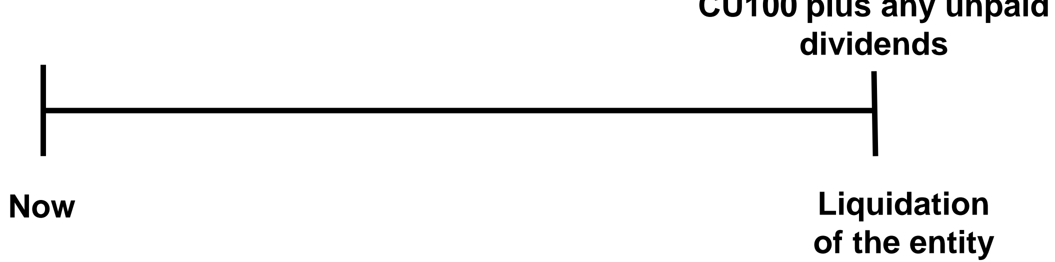


Should it be classified as liability or equity?		
Timing Feature	Any obligation to transfer cash before liquidation?	✓
Amount Feature	Return on instrument independent?	✗

Classified as a financial liability

DP proposals—Example #3

- Preference shares that pay dividends of 5% (per annum) of the notional amount, CU100
- The entity can defer the dividends payment until liquidation
- In the event of liquidation of the entity, any unpaid dividends and the notional amount will become due



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

Classified as a financial liability

DP proposals—Presentation of financial liabilities

- The returns on some financial liabilities behave like equity instruments. They are a cash claim like a simple bond. However, the value of the claim is linked to the "residual value" of the entity eg shares redeemable for a cash amount equal to the fair value of ordinary shares.

Does the return on the financial liability behave like the return on an equity instrument?

NO

Profit or Loss	
Income and expenses from financial liabilities that have debt-like return	X/(X)
Profit	XXX

YES

Statement of other comprehensive income	
Income and expenses from financial liabilities that have equity-like return	X/(X)
Other comprehensive income	XXX

No recycling to profit or loss even if realised

DP proposals—Presentation of equity instruments

Attribution of income **today**
Profit or loss and other comprehensive income (OCI) → Owners of the parent; NCI

Proposed attribution would show further information about returns on each class of equity instruments. For example…

Owners of the parent → Preference shareholders; Share warrant holders; Ordinary shareholders

Q. Attribution on what basis?
Changes in fair value? Changes in fair value relative to that of ordinary shares?
Disclosure of changes in fair value instead of presentation?

DP proposals—Disclosures

Priority on liquidation	• Liquidation priority of all financial liabilities and equity instruments at reporting date
Maximum dilution of ordinary shares	• Applies to financial instruments that may be settled in own shares • Shows maximum number of ordinary shares that an entity may need to deliver to settle such financial instruments outstanding at the reporting date, eg assuming all convertible bonds will be converted into shares • A reconciliation of movement during the period
Terms and conditions	• Applies to financial liabilities and equity instruments • Terms and conditions that are relevant to determining the timing and amount of cash flows of a financial instrument • For example, if the issuer has an option to redeem an instrument, the timing and the amount and if it depends on a trigger event, the description of that event

Overview of the feedback received on the DP

Classification

- Timing feature
- Amount Feature
- Contractual terms

Presentation

- Separate presentation of financial liabilities
- Attribution within equity

Disclosure

- Priority on liquidation
- Maximum dilution of ordinary shares
- Terms and conditions

Key

- Green: Broadly agree with some limited qualification/question
- Amber: Partially agree with a number of concerns
- Red: Broadly disagree and a significant level of concerns raised

Timeline

June 2018
Discussion paper published

January 2019
Comment deadline ended

March 2019
High level summary of feedback received

Currently
Detailed analysis of feedback received

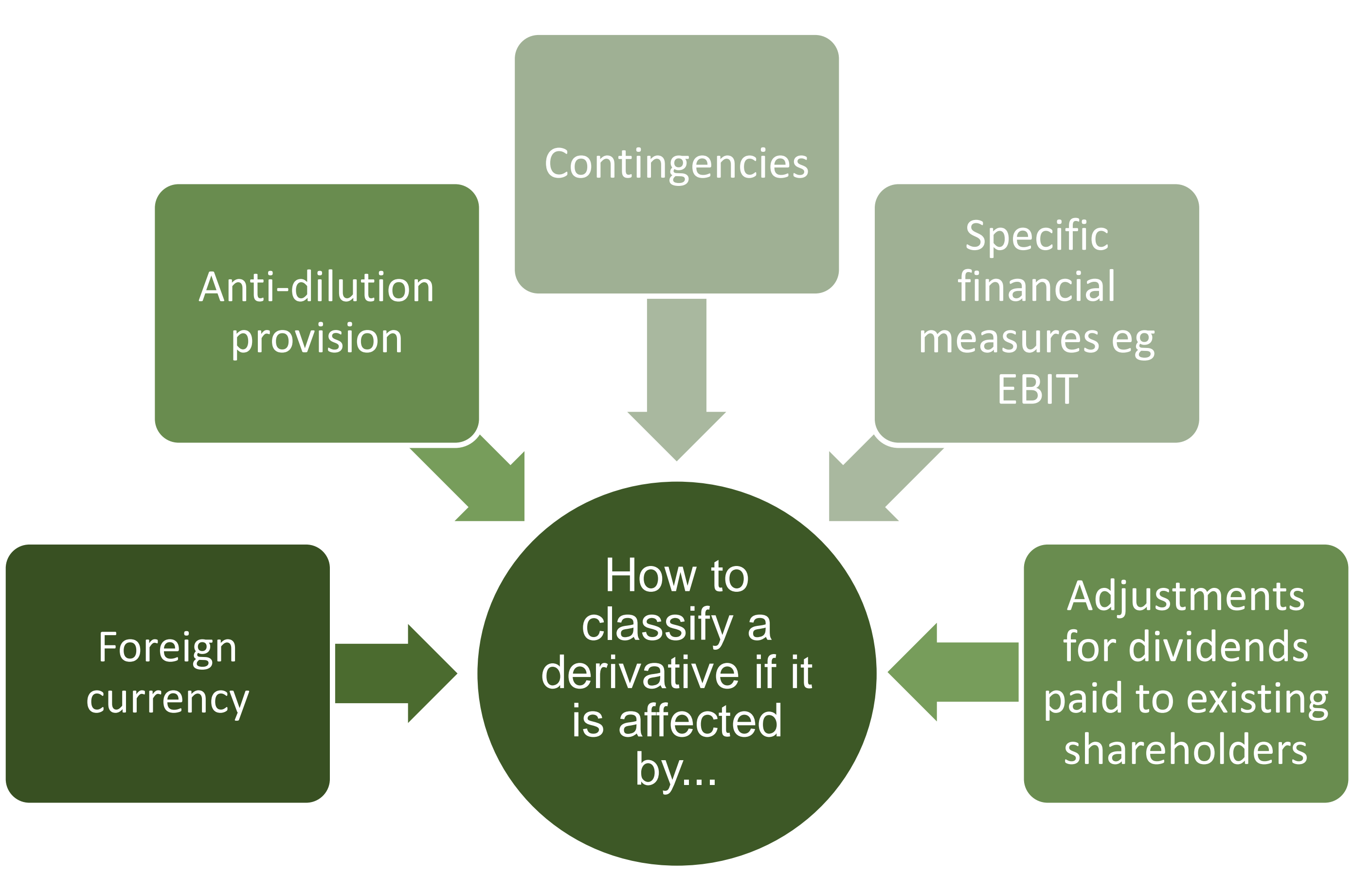
H2 2019
Decide project direction

Appendix: Background information

DP proposals—Derivatives on own equity

Practice questions often arise on what 'fixed' means in the so-called 'fixed for fixed' condition in IAS 32

The DP includes a discussion on how the proposed approach applies to derivatives that are affected by different variables



DP proposals—Classification of puttable shares and NCI puts

Shares issued at CU100
Puttable in one year at CU90
How to reflect obligation to pay cash to redeem underlying shares?

Put obligation

Today (IAS 32)
- Recognise CU100 obligation

DP proposals
- Same as above

Underlying shares

Today (IAS 32)
- 'Reclassify' from equity– Show as outstanding? Derecognise?

Issues
- Diversity in accounting
- More significant implications in the case of 'NCI puts'
- Double counting if shown as outstanding
- Visibility of changes in the value of the holder's option to keep or put the shares

DP proposals
- Derecognise shares
- Recognise an implicit written call option representing the holder's right to keep the shares, which may be classified as equity

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