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STAFF PAPER

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IASB Meeting

Project	**Financial Instruments with Characteristics of Equity research project**
Paper topic	Scope of separate presentation requirements for liabilities that depend on the residual amount

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Introduction

1. In February 2016, we considered whether changes in liabilities that depend on the residual amount should be distinguished in some way either within profit or loss, or in other comprehensive income, and whether their carrying amounts should be distinguished in the statement of financial position. For convenience, we refer to these proposals as the 'separate presentation requirements'.

2. The Board indicated that if a claim that depends on the residual amount and is classified as a liability, it would be useful to distinguish and present separately income and expense arising from such a liability.

3. At that meeting, we did not offer a definition for the subclass of liabilities that would apply the separate presentation requirements, but observed that one type of instrument for which it would be useful would be an ordinary share[1] redeemable by the holder at fair value that does not meet the puttable exception in IAS 32 *Financial Instruments: Presentation*.

4. The implication of the discussion in February 2016 was that an additional sub-class of financial liabilities would be required to separately present the amounts arising from financial liabilities that depend on the residual amount. As noted by

[1] an ordinary share being an obligation that requires the entity to transfer economic resources only at liquidation for an amount equal to the fair value of a claim to a pro-rata share of the entity's net assets on liquidation

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some Board members, IFRS 9 *Financial Instruments* includes requirements for the recognition, measurement and presentation of amounts related to various classes of financial liabilities. Those requirements also include the accounting for embedded derivatives. Any new or additional subclass of liabilities will have to interact with both the requirements of IAS 32 and IFRS 9.

5. The purpose of this meeting is to continue the Board's discussion by considering whether the subclass of instruments for the separate presentation requirements should include types of financial liabilities that depend on the residual amount other than those considered in paragraph 3.

6. As agreed last month, we are focusing on the Gamma Approach. Under approach Gamma, a liability includes an obligation:

   (a) to transfer economic resources at particular points in time other than at liquidation or

   (b) for a specified amount independent of the economic resources of the entity.

7. Because approach Gamma will classify as a liability a claim with either one of two features (amount and timing), two different types of income and expense will be captured:

   (a) Changes in the carrying amount arising from promised returns[2], (for example, changes arising from interest accretion on ordinary bonds, cumulative preference shares, and share-settled bonds); and

   (b) Changes in the carrying amount arising from changes in the residual amount[3], (for example, changes in shares redeemable at fair value).

8. We have taken the following approach:

[2] These meet the definition of income and expense under the Gamma approach because a transfer of economic resources is required other than at liquidation, and because of the obligation for an amount independent of the entity's economic resources.

[3] These meet the definition of income and expense under the Gamma approach only because a transfer of economic resources is required other than at liquidation.

(a) Firstly, we identify the different financial liabilities that might depend on the residual amount, and thus might be candidates to apply the separate presentation requirements.

(b) Secondly, we summarise the possible ways that these financial liabilities might be accounted for applying IFRS 9. Applying the requirements of IFRS 9, the instruments identified might be accounted for in more than one possible way.

(c) Finally, we explore different ways that we might apply the separate presentation requirements to the liabilities that we identified, given how they might be accounted for under IFRS 9.

9. The purpose of this paper is not to set the definition of a residual amount. As we mention in Agenda Paper 5, we will consider refinements to the definition of a residual amount, including a discussion of the fixed-for-fixed condition at a future meeting. This would include considering the classification as liabilities or equity of foreign currency rights issues and foreign currency convertible bonds in the light of the Gamma Approach and the presentation proposals developed for subclasses of liabilities and equity. For convenience, we have limited the examples considered in this paper to simple fixed-for-fixed financial instruments.

10. The main issue we discuss in this paper is the balance between:

(a) maximising the benefits of applying the separate presentation requirements at a granular level to all financial liabilities that depend on the residual amount; and

(b) minimising the costs and complexity of separately identifying all financial liabilities that depend on the residual amount, and managing the interaction of those requirements with IFRS 9.

11. Based on the analysis in this paper, we suggest that separate presentation requirements should apply to standalone derivatives that depend on the residual amount. For hybrid contracts that contain embedded derivatives that depend on the residual amount, we identify two approaches which strike a different balance between the costs and benefits outlined above, and ask the Board whether it prefers one of the approaches.

Structure

12. This paper is structured as follows:

    (a) What is the population of the instruments that will be affected? (paragraphs 13–23)

    (b) Should standalone derivatives that depend on the residual amount be subject to the proposed separate presentation requirements? (paragraphs 24–37)

    (c) How should the separate presentation requirements apply to embedded derivatives that depend on the residual amount? (paragraphs 38–51)

What is the population of the instruments that will be affected?

13. Depending on the characteristics of the instruments, the entity might have more than one option for accounting for the instrument under IFRS 9.

14. Applying IAS 32 and IFRS 9 to a *derivative financial instrument* an entity either accounts for the instrument as an equity instrument (if it does not meet the definition of a financial liability) or as a financial liability measured at fair value through profit or loss.[4]

15. Applying IAS 32 and IFRS 9 to a non-derivative financial instrument an entity is generally required to identify whether the financial instrument is a compound financial instrument.[5] If so, then the entity separates the financial liability component and equity component and applies the requirements of IFRS 9 to the financial liability component, which could be either a derivative or a non-derivative financial liability[6].

16. More specifically, applying IFRS 9 to a non-derivative financial instrument an entity is generally required to identify whether the financial instrument is a hybrid

[4] IFRS 9 paragraph 4.2.1(a)

[5] IAS 32 paragraph 28

[6] The financial liability component could also be a hybrid instrument that has a non-derivative host and embedded derivatives

instrument (ie if it contains an embedded derivative).[7] An embedded derivative could be either;

(a) a non-option embedded derivative.

(b) an option embedded derivative.

17. In case of a hybrid financial instrument the entity first needs to decide whether to apply the option to classify the hybrid instrument as a whole at fair value through profit or loss (the fair value option).[8] If not applying the fair value option, then IFRS 9 requires the entity to separate the embedded derivatives from the host contract unless the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host. The financial liability host contract is classified as subsequently measured at amortised cost, and the embedded derivative is classified as a financial liability, or financial asset, measured at fair value through profit or loss.[9]

18. If the financial liability depends on the residual amount, then it is likely that this would meet the definition of an embedded derivative that would need to be separated. Furthermore, paragraph B4.3.5(c) of IFRS 9 states that:

> Equity-indexed interest or principal payments embedded in a host debt instrument or insurance contract—by which the amount of interest or principal is indexed to the value of equity instruments—are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.

19. Based on the above, we can identify the following types of financial liabilities that might be candidates to apply the separate presentation requirements:

(a) Standalone derivatives that depend on the residual amount and are classified as a financial liability measured at fair value through profit or loss.

[7] IFRS 9 paragraph 4.3.1

[8] IFRS 9 paragraph 4.3.3(c)

[9] IFRS 9 paragraph 4.3.3

(b) Hybrid instruments containing embedded derivatives that depend on the residual amount. For these contracts, the embedded derivative that depends on the residual amount would either be:

(i) Not separated from the host contract if the whole hybrid instrument is classified as a financial liability measured at fair value through profit or loss; or

(ii) Separated from the host contract and classified as a financial liability measured at fair value through profit or loss.

20. Importantly, all of the above instruments are measured at fair value through profit or loss. The objective would be to limit the application of the separate presentation requirements to changes in the fair value of the instrument that result from a change in the residual amount. In our view, the separate presentation requirements should not apply to changes in the fair value of the instrument that do not result from changes in the residual amount.[10]

21. The following questions arise from the above:

(a) Should the separate presentation requirements apply to standalone derivatives if they depend on the residual amount? (paragraphs 24–37)

(b) How should the separate presentation requirements apply to embedded derivatives if they depend on the residual amount? (paragraphs 38–51)

22. If the Board does not think that any derivatives should be subject to different presentation requirements, then the above questions do not need to be addressed.

23. At one extreme, the separate presentation requirements could be limited simply to ordinary shares that are redeemable at fair value on demand. At the other extreme, all standalone and embedded derivatives that depend on the residual amount are separately identified and apply the separate presentation requirements.

[10] However we plan to consider further refinements to the definition of a residual amount, including a discussion of the fixed-for-fixed condition at a future meeting.

Should standalone derivatives that depend on the residual amount be subject to the proposed separate presentation requirements?

24. In February 2016, we did not offer a definition for the subclass of liabilities that the separate presentation requirements will apply to, but we suggested that one class of instrument that the separate presentation requirements will be useful for would be an ordinary share redeemable at fair value.

25. Furthermore, we suggested in February 2016 that we will consider the scope of the separate presentation requirements carefully. This was because one presentation alternative that the IASB is considering would present the changes in these liabilities in other comprehensive income, similarly to changes in own credit.

26. We consider two examples below of standalone derivatives that depend on the residual amount before we consider whether or not the presentation requirements should apply:

    (a) A net cash settled fixed-for-fixed forward contract to issue shares

    (b) A net cash settled fixed-for-fixed written warrant to issue shares

27. As we mentioned in paragraph 9, we will consider refinements to the definition of claims that depend on a residual amount, including a discussion of refinements to the fixed-for-fixed condition at a future meeting.

A net cash settled fixed-for-fixed forward contract to issue shares

28. First, consider a physically settled forward contract to issue a fixed number of equity instruments in exchange for receiving a fixed amount of cash. Such a derivative would be classified as equity under the Gamma approach. However, if that forward contract was net cash settled instead of being physically settled (for example, a total return swap), then the contract would meet the definition of a financial asset or liability under the Gamma approach.

29. Notwithstanding the obligation to pay cash, the amount of the net cash settled forward contract will be subject to the same drivers of value changes as the physically settled forward contract and an ordinary share redeemable at fair value. That is, it would be dependent on the residual amount. Thus, the changes in the

value of the contract will be driven by changes in the entity's economic resources and changes in other claims.

30. In other words, the *changes in value* of an obligation to pay cash equal to 100 of an entity's ordinary shares would be the same as the *changes in value* of a forward contract to pay the difference between CU100 and the value of 100 of the same shares. If the entity's share price increases (or decreases) by CU10, then both the shares redeemable at fair value and the forward contract will increase (or decrease) by CU1000 (CU10 x 100 shares).

31. The difference would be that the initial net investment would be smaller for the derivative than the shares redeemable at fair value, even though they have similar responses to the same changes. That is, it is levered.

A net cash settled fixed-for-fixed written warrant to issue shares

32. Another example to consider would be a physically settled written warrant to issue a fixed number of equity instruments in exchange for receiving a fixed amount of cash. Such a derivative would be classified as equity under the Gamma approach. However, if that written warrant was net cash settled, then the derivative would meet the definition of a liability under the Gamma approach.

33. Notwithstanding the obligation to pay cash, the amount of the net cash settled warrant contract will be subject to the same drivers of value changes as the physically settled warrant contract. That is, it would be dependent on the residual amount. Thus, the changes in the value of the contract will be driven by changes in the entity's economic resources and changes in other claims.

34. For the warrant, unlike the forward contract, the changes in the fair value would also include changes in the time value of the option. Therefore, the changes in the fair value of the warrant will not be to the same as the changes in the underlying ordinary shares like the forward contract. However, the changes in the time value of the option would still be driven by the residual amount.

Should the separate presentation requirements apply to derivatives?

35. Even though the changes discussed in the examples above arise from derivative contracts, and therefore the changes in proportion to the net carrying amount are levered, accounting for those changes would raise the same challenges that we

discussed in February 2016 for the ordinary share that is redeemable at fair value because they depend on the same residual amount. These challenges include:

(a) the need to distinguish between the changes in claims that are independent of the entity's economic resources and other claims (the promised returns), and changes in claims that depend on the residual amount, to provide useful information that will help a user understand the drivers of the entity's performance.

(b) the consequences of the incomplete recognition and mixed measurement of assets and liabilities. Claims that depend on the residual amount will depend on changes that are unrecognised. Therefore, recognising changes in such claims without also recognising what those changes depend on may result in financial statements that appear counterintuitive.

36. Furthermore, because the changes in derivatives that depend on the residual amount are similar to changes in shares redeemable at fair value, then it would improve comparability if the same presentation requirements applied to both.

37. Based on the above, in the staff's view, the subclass of liabilities for the separate presentation requirements should be expanded to include standalone derivatives that are classified as liabilities at fair value through profit or loss, and that depend on the residual amount.

How should the separate presentation requirements apply to embedded derivatives that depend on the residual amount?

38. As we show in paragraphs 13–19, hybrid instruments might contain embedded derivatives that depend on the residual amount. These instruments do not fully depend on the residual amount, but have a component that does. For example, an otherwise typical ordinary bond that includes an 'equity kicker' that on maturity obliges the entity to pay cash for the excess of a fixed number of the entity's ordinary shares above the principal amount of the bond.

39. For these contracts, the embedded derivative that depends on the residual amount would either be:

(a) Not separated from the host contract if the whole hybrid instrument is classified as a financial liability measured at fair value through profit or loss; or

(b) Separated from the host contract and classified as a financial liability measured at fair value through profit or loss.

40. Last month we looked at ordinary shares that are redeemable on demand at fair value. For such hybrid instruments the requirements of IFRS 9 result in the same accounting for an ordinary share redeemable at fair value on demand regardless of whether the embedded option is separated or if the contract was measured at fair value through profit or loss as a whole. As noted in IFRS 9, paragraph B4.3.7:

> "in the case of a puttable instrument that can be put back at any time for cash equal to a proportionate share of the net asset value of an entity … , the effect of separating an embedded derivative and accounting for each component is to measure the hybrid contract at the redemption amount that is payable at the end of the reporting period if the holder exercised its right to put the instrument back to the issuer."

41. However, for many other hybrids, there will be a difference between separating an embedded derivative, and accounting for each component, compared to measuring the hybrid instrument as a whole at fair value through profit or loss. For example, applying the fair value option to the bond with an 'equity kicker' will result in the changes in fair value including both changes in the residual amount and changes resulting from interest and credit risk of the bond host. In the staff's view, it would not meet the objective of the separate presentation requirements if they were applied to changes in the fair value of the instrument that do not result from changes in the residual amount.

42. Therefore, in the staff's view, there are two approaches to applying the separate presentation requirements to hybrid instruments that contain an embedded derivative that depends on the residual amount:

(a) **Approach A:** Apply the separate presentation requirements only to embedded derivatives that depend on the residual amount and are

separated. Do not apply the separate presentation requirements to any hybrid instruments that are classified as fair value through profit or loss.

(b) **Approach B:** Require an entity to separate out embedded derivatives that depend on the residual amount under all circumstances and apply the separate presentation requirements to all embedded derivatives that depend on the residual amount.

Approach A

43. Approach A would keep the existing requirements in IFRS 9 that allow the entity to either separate out embedded derivatives or apply the fair value option to the hybrid instrument as a whole. However, this approach will only apply the separate presentation requirements to embedded derivatives that are separated and depend on the residual amount. This is because the fair value changes for hybrid instruments that are not separated could include changes that do not depend on the residual amount, such as changes in amounts independent of the entity's economic resources and changes in own credit risk.

44. The advantage of Approach A is that it would be fairly easy to implement within the context of the existing recognition and measurement requirements of IFRS 9. All that will be needed is to set out the separate presentation requirements that will apply to embedded derivatives that depend on the residual amount that are separated.

45. The disadvantage of Approach A is that it would be the loss of comparability that arises from the fair value option. However, one of the reasons for allowing an entity to classify a hybrid instrument at fair value through profit or loss was to reduce the costs and complexity of separating out embedded derivatives. In the staff's view, this cost/benefit argument might also be applicable to embedded derivatives that depend on the residual amount.

Approach B

46. Approach B would require an entity to separate, and apply the separate presentation requirements to, all embedded derivatives that depend on the residual amount.

47. The main advantage of Approach B would be that it would better represent all embedded derivatives which depend on the residual amount.

48. The objective of the separate presentation requirements is to distinguish those changes in liabilities that depend on the residual amount. The key advantage of Approach B is that it accomplishes this objective better as compared to Approach A. Under Approach A changes that will be presented in profit or loss will include changes arising from changes in the residual amount amongst other changes if embedded derivatives are not separated.

49. The main disadvantage of Approach B is the added cost and complexity of introducing mandatory additional separation requirements for financial liabilities.

Summary

50. For hybrid contracts that contain embedded derivatives that depend on the residual amount, we identify two approaches above which strike a different balance between the costs and benefits:

    (a) Approach B maximises the benefits of applying the separate presentation requirements in a granular level to all financial liabilities that depend on the residual amount; and

    (b) Approach A minimises the costs of complexity in separately identifying all financial liabilities that depend on the residual amount, and managing the interaction of those requirements with IFRS 9.

51. We think that the forthcoming discussion paper should explore both approaches.

Questions for the Board
Does the Board agree the subclass of liabilities for the separate presentation requirements should be expanded to include standalone derivatives that are classified as liabilities at fair value through profit or loss, that depend on the residual amount? (paragraph 37) Does the Board have a preference between Approach A and Approach B for embedded derivatives in hybrid contracts? Does the Board agree that both approaches should be included in the Discussion Paper? Are there any other approaches that the Board thinks we should explore?