STAFF PAPER

September 2016

IASB Meeting

Project	Financial Instruments with Characteristics of Equity		
Paper topic	Disclosure		
CONTACT(S)	Daisy Yang	dyang@ifrs.org	+442072462552
	Manuel Kapsis	mkapsis@ifrs.org	+442072466459

Introduction

1. We have previously stated that financial statements need to provide information about relevant features of claims through classification, presentation and disclosure. To date, we have focused our discussions on classification and presentation of financial liabilities and equity in the statement of financial position and related effects in the statement(s) of financial performance. The objectives of this paper are to:

   (a) explore how disclosures might complement the approaches to classification and presentation in terms of providing useful information on features of claims (both liabilities and equity) to help users make the assessments we have identified.

   (b) provide disclosures on equity at the same level as with liability disclosures, enabling users to make an informed assessment for all claims regardless of their classification.

2. At present, there is a significant difference between the information provided for items classified as equity and those classified as liabilities. We have looked at how we can reduce that difference using presentation, however this difference in information also applies to disclosures. The Board has not considered disclosures for equity instruments as part of previous projects, including the predecessor

project on Financial Instruments with Characteristics of Equity or the project that led to the publication of IFRS 7 *Financial Instruments: Disclosures*.

3. However, the objective is not to simply add more disclosure, but to look at existing disclosure requirements to see whether they can be made more effective. This involves considering whether existing requirements can be removed or modified, and justifying any additional requirements.

4. Based on the analysis in this paper, we suggest that the future Discussion Paper includes a discussion of the following potential disclosures:

   (a) the priority of claims on liquidation;

   (b) potential dilution of ordinary shares; and

   (c) additional information to support the presentation and classification requirements under the Gamma approach.

Structure

5. This paper is structured as follows:

   (a) Background (paragraphs 6–19)

   (b) Research performed on user needs (paragraphs 20–36)

   (c) Staff analysis (paragraphs 37–85)

   (d) Summary and question for the Board (paragraphs 86–87)

Background

6. In Agenda Paper 5A we set out the objectives of the project and Board’s approach to addressing the identified challenges. This includes:

   (a) reinforcing the underlying rationale of the distinction between liabilities and equity in IAS 32 *Financial Instruments: Presentation*;

   (b) providing better information through presentation and disclosure; and

   (c) improving the consistency, completeness and clarity of the requirements.

7. The Board has already made progress on identifying what information is best provided using classification and presentation. As part of developing the approaches to classification and presentation we have identified:

   (a) the features of claims against an entity that are relevant to users; and

   (b) the relevance of those features to the assessments of financial position and financial performance.

8. In developing the approach to disclosure, we consider the features of claims and user assessments which we identified in previous meetings. In addition, we consider user requests received in the past for improvements to information provided about liabilities and equity.

9. The rest of this section discusses:

   (a) Scope and approach (paragraphs 10–12)

      (i) Our approach

      (ii) Principles of disclosure project

   (b) Classification and presentation under the Gamma approach (paragraphs 13–19)

Scope and approach

10. This paper explores possible disclosures to meet users' information needs for both liability and equity claims. The proposed disclosure requirements will apply to financial instruments, in particular financial liabilities and equity instruments.

Our Approach

11. In developing a disclosure package the staff's approach has been to:

   (a) perform a high-level review of the information requested by investors and other users about liabilities and equity in their response to other IASB consultations (see paragraphs 20–36);

   (b) consider what information can be communicated through disclosures to meet the user needs identified in (a), within the scope of this project, and to support the classification and presentation requirements being developed, focusing on the Gamma approach;

(c) consider how existing requirements could be improved to provide the information in (b), including considering whether any existing requirements could be removed, and justifying any additional requirements.

Principles of Disclosure project

12. As part of the Principles of Disclosure project, the Board is developing drafting guidelines for Standards-level disclosures. The approach we are taking in this paper is not inconsistent with the proposed drafting guidelines. However, at this stage we are aiming to identify the particular disclosures that would support the classification and presentation requirements and provide relevant information to users of financial statements. The drafting guidelines would apply at a later stage of the project, when the IASB begins developing the specific Standards-level requirements based on input on the Discussion Paper.

Classification and presentation under the Gamma approach

13. The classification and presentation approach under Gamma is based on the features of claims we identified earlier (please refer to paragraphs 21 and 22 in Agenda Paper 5A). However, classification and presentation does not capture all the features of claims needed for user assessments (See Assessments A, B & Y in paragraph 14). Our focus is to identify those features that were not captured by classification and presentation under the Gamma approach and so need to be communicated through disclosure. Below we have a brief overview of the classification and presentation approach.

14. Approach Gamma focuses the distinction between liabilities and equity on both:

(a) the **timing** of required settlement which is relevant to assessing the extent to which the entity is expected to have the economic resources required when it is required to transfer them (Assessment A); and

(b) the **amount** of economic resources required to settle the claim, which is relevant to assessing the extent to which the entity has:

(i) sufficient economic resources to satisfy the total claims against it if they were all to be settled at a point in time (Assessment B); and

(ii) produced a sufficient return on its economic resources to satisfy the promised return on claims against it (Assessment Y).

15. Under the Gamma approach, a liability includes an obligation:

(a) to transfer economic resources at particular points in time other than at liquidation; <u>or</u>

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

16. All other claims will be classified as equity. This means that instruments classified as equity:

(a) do not require transfer of economic resources prior to liquidation; and

(b) are obligations for an amount that depends on the residual amount.

17. Under the Gamma approach, financial instruments that depend on a residual amount are not always classified as equity – some of them are classified as liabilities if they require transfer of economic resources prior to liquidation. Hence, it would be useful to present separately liabilities that depend on a residual amount, and to distinguish between:

(a) income or expense that arises from liabilities for a specified amount, ie an amount that is determined independently from the entity's economic resources; and

(b) income or expense that arises from liabilities that depend on a residual amount.

18. In order to provide information about the distribution of returns amongst various equity claims with a higher priority than ordinary shares, the Board thinks it would be useful to:

(a) attribute profit or loss and other comprehensive income to classes of equity other than the ordinary shares of the parent entity;

(b) update the carrying amount of each class of equity to reflect any such attribution.

19. The attribution requirements might reduce the need for some existing disclosures about the dividends on preference shares, such as the disclosures required by paragraph 137 of IAS 1 *Presentation of Financial Statements*.

Research performed on user needs

20. We have, as part of developing the classification and presentation requirements, identified a number of user information needs, which formed the basis of features of claims and user assessments as identified earlier. However, because disclosure is broader than the classification and presentation of recognised liabilities and equity, we have undertaken limited research to ensure we capture the information users need to understand claims on an entity's economic resources and its capital structure. We then consider how to satisfy those user needs through disclosures, within the scope of this project.

21. Our research included reviewing user responses to the following documents:

(a) the Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* (the Conceptual Framework Discussion Paper);

(b) Agenda Consultations 2011 and 2015;

(c) the IASB's Investors Perspective article *Better communication – A table is worth 1000 words*;

(d) The 2008 Discussion Paper *Financial Instruments with Characteristics of Equity*.

22. We have not performed a detailed comment letter analysis, partly because the responses were to consultations that had a different scope and objectives to the current project. Our intent was to identify broad user needs for information about liability claims and equity claims, as well as an entity's overall capital structure, to supplement our existing analysis of what is relevant in terms of the recognised amounts.

23. We aim to consider user information needs that we think are within the scope of this project. We have made that assessment based on the extent that those needs confirm or supplement the features of claims we identified as being relevant to particular assessments (please refer to paragraphs 21 and 22 in Agenda Paper 5A). This analysis forms part of the basis for proposing disclosures that complement the approaches to classification and presentation under Gamma.

24. Based on our research, we identified the major themes as listed below. We did not include all details of the specific disclosures requested by users.[1] Instead, we explain under each theme, the extent we think information to meet those user needs is within the scope of this project.

25. Themes identified included:

    (a) Information about a financial instrument in its entirety, regardless of whether it is classified as liabilities or equity, or bifurcated;

    (b) Information on potential dilution of equity claims through the issuance of additional units of equity claims;

    (c) Information about material variances in rights and returns of all equity claims;

    (d) Information on the overall capital structure of an entity and the priority of claims on an entity's economic resources; and

    (e) More detailed information about the entity's financial debt and liquidity.

Information about a financial instrument in its entirety, regardless of whether it is classified as liabilities or equity, or bifurcated

26. Users' requests for information regardless of classification reflect the concern that classification alone would not faithfully represent features of many ever increasingly complex financial instruments (eg hybrid instruments).

27. In this respect, users requested particular information about the nature, terms and conditions, features and priority of a financial instrument in its entirety. They also

[1] Many of the specific disclosures requested by users had different forms although the content was similar. We have tried to focus on identifying the content of the disclosures.

requested fair value information on liability[2], equity and financial instruments which participate in the upside potential of an entity.

28. In our view, these user information needs are within the scope of this project and are considered in this paper, as they reflect a concern with the inherent limitation of using recognition to capture all information users need on liability and equity claims.

Information on potential dilution of equity claims through the issuance of additional units of equity claims.

29. Users supported suggestions in various consultations to provide additional information about the distribution of returns through classification and presentation (eg through the statement of changes in equity as suggested in the Conceptual Framework Discussion Paper). However, they suggested that this might need to be supplemented by expanded disclosure of potential dilution in different scenarios.

30. Users requested particular information about all potential sources of dilution at year end, the number of ordinary shares outstanding, sources and timing of new issuance of ordinary shares, and share repurchase plans. We think these information needs are within the scope of the project because information about potential dilution helps users to understand the distribution of returns to individual ordinary shares, which is not only affected by what claims rank ahead of ordinary shares, but also the number of ordinary shares outstanding.

31. Users also requested particular information about how new issuance of ordinary shares impacts the voting rights of existing shareholders. In our view information about voting rights is outside the scope of this project, as we previously concluded in Agenda Paper 5A June 2015 that voting rights are not relevant features of claims because they do not directly affect the prospects for cash flows on the claim. Hence, we do not propose to require disclosures of terms and conditions on voting rights as part of this project. However, we note the impact of new issuance of ordinary shares on the voting rights of existing shareholders is typically a direct consequence of dilution. Therefore, because we think that

[2] We note that disclosure of fair value information on liability is already required in paragraph 25 of IFRS 7

information can be conveniently provided along with dilution, we consider it in this paper even though we think it is beyond the scope of the project.

32. Different users have varied opinions on the particular forms of dilution analysis they prefer. We have not considered the merits of the various forms of dilution analysis suggested, because we think providing the underlying information should enable users to construct their own forms of dilution analysis.

Information about material variances in rights and returns of all equity claims.

33. Users requested information to help them better asses the precise risks and rewards for each equity instrument.

34. Users requested particular information about terms and conditions and about equity instruments issued and redeemed during the year. We think providing this information targets users' concerns that there is currently a lack of disclosure about equity claims and also meets one of our objectives to provide disclosures on equity at the same level as liability disclosures.

Information on the overall capital structure of an entity and the priority of claims on an entity's economic resources

35. Users requested particular information on a comprehensive list of all claims and the priority of claims (ie the 'waterfall'). We think these information needs are within the scope of the project because we previously identified 'priority' as a relevant feature of claims. We have only partially addressed this feature through the classification and presentation requirements under Gamma. We think more comprehensive information can be provided on this feature through disclosures.

More detailed information about the entity's financial debt and liquidity

36. Financial statements provide information to assess the entity's liquidity. Information about financial liabilities that require the transfer of cash prior to liquidation will help users understand the cash demands against the entity. We discuss this in our analysis in paragraphs 80–85. However, information about other aspects of liquidity is beyond the scope of this project. This includes some information requested by users, for instance information about where the financial

debt resides within an entity's group structure, internal restrictions placed on a parent entity's liquidity, the liquidity of particular assets etc.

Staff analysis

37. We have analysed the user needs identified in paragraphs 26–36 in further detail in the following sections:

    (a) What disclosures do we need to address information needs not met through classification and presentation? (paragraphs 38–65)

    (b) What disclosures do we need to improve users' understanding of the information communicated through classification and presentation? (paragraphs 66–85)

What disclosures do we need to address information needs not met through classification and presentation?

38. The classification approach under Gamma is based on the **timing** and **amount** features of claims. The presentation approach provides further information on these features. However, neither classification nor presentation directly provide information about the **priority** feature, which is relevant for assessing the allocation of economic resources, and returns on those resources, (ie 'waterfall' structure of an entity). Currently there is no information required under IFRS Standards about the priority of claims. We also identified in paragraph 22(d) that users need information on priority of claims. Hence, we think it is important to provide this information through disclosure.

39. In addition, we identified in paragraph 22(b) that users need information on potential dilution of ordinary shares. In this paper we regard dilution as any actual or potential increase in the number of issued ordinary shares, caused by the settlement of either liability or equity, consistent with users' opinions on dilution as identified in our research. While the classification and presentation captures some aspects of potential dilution of ordinary shares, additional information about

both liabilities and equity that are settled using ordinary shares could help users assess the effect on ordinary shareholders.

40. Consequently, we consider what information is best provided on these two features present in both liability and equity instruments:

(a) Priority (paragraphs 41–51); and

(b) Potential dilution (paragraphs 52–65).

Priority

41. In previous meetings, we identified the priority of a claim on liquidation as a relevant feature. We noted that, in addition to information about the **amount** of an obligation, users will also need information about the **priority** of the claims on liquidation to assess how any potential shortfall, or excess, of economic resources, and returns on those economic resources, will be distributed amongst claims.

42. None of the approaches we are considering for classification use the priority of the claim on liquidation directly. This is partly because the priority of a claim is a feature that is relative to other claims against the entity.

43. In February 2016, we suggested that an entity could present liabilities in order of priority on the face of the financial statements, or in the notes, to provide information to users. This would be as an alternative, or in addition to, presenting liabilities as current or non-current, or in the order of liquidity, as required by IAS 1.

44. Currently there is no requirement in IFRS Standards to disclose any information about the priority of claims.

45. We observe that both within liability and equity classes, there is a variety of claims with different possible levels of seniority and subordination. On the other hand, the current IFRS requirement to bifurcate compound instruments and some hybrid instruments into liability and equity components could make it difficult to see the seniority of the entire instrument compared to other instruments.

46. In order to address the information gap, we propose the following objective of disclosure about the priority of claims:

> An entity should provide information to help users assess how an entity's capital structure, including the priority of financial instruments, affects how various claim holders participate in the entity's prospects for future cash flows.

47. In our view the information to meet the disclosure objective could be provided as follows:

    (a) an entity could provide a complete list of all financial liabilities and equity and rank each group of instruments in the order of priority in sharing an entity's economic resources and returns.

    (b) in relation to each group of financial liability and equity, disclose:

        (i) terms and conditions which indicate its priority within the entity's capital structure (eg liquidation preference, the existence of guarantees and collateral, interest and dividend pushers and stoppers etc.);

        (ii) terms and conditions which potentially could lead to changes in the priority (eg conversion features, contingent features, etc.);

        (iii) terms and conditions which indicate its promised returns and/or rights to dividends or other distributions; and

        (iv) any other features which affect its capacity to share in an entity's economic resources and returns.

    (c) if there is any change in the priority of any group of financial instruments, disclose the reasons for the change such as changes in relevant terms and conditions or circumstances.

48. We suggest that for purpose of this disclosure, entities could group financial instruments together, if the financial instruments have similar terms and conditions which indicate that they are on the same level of priority.

49. We also think that the above disclosures could be provided in a tabular format, similar to a capitalization table as required in the lodgement of Form S-1 for the initial listing of securities in the US market by the Securities and Exchange Commission (SEC). Below is an example of what a capitalization table might look like. The example is taken from the IASB's Investors Perspective article *Better communication – A table is worth 1000 words*.

Capitalisation Table	**As of 01 Jan. 20XX In CU**
Senior secured loan	2,500
Junior secured loan	1,500
Subordinated note(s)	1,000
Finance leases	450
Pension plan deficit	500
Other financial liabilities	500
Liabilities	**6,450**
Non-cumulative preference shares	1,000
Non-controlling interest	415
Shareholders' equity	1,350
Total group equity	**2,765**
Total capitalisation	**9,215**

Advantages and disadvantages of disclosing information about priority

50. We think the proposed disclosure about priority would provide the following benefits for users:

(a) Provides information on an entity's capital structure in a single place in a tabular format. This alleviates the current burden on users having to piece together this information from multiple sources of reports;

(b) Information on the priority feature helps users to assess how any potential shortfall, or excess, of economic resources, and returns on those economic resources, will be distributed amongst claims.

(c) Responds to the user needs identified for information on entire financial instruments (paragraph 22(a)), capital structure and priority of claims (paragraph 22(d)).

(d) It would apply equally to liabilities and equity instruments, thus users would get the same information regardless of the classification of the instrument. It also meets the objective in paragraph 1(b) to raise the quality of equity disclosures. Currently if a financial instrument (or part thereof) is classified as equity, it is subject to limited disclosure requirements. The proposed disclosure enables users to also assess the priority feature of equity instruments (or components).

51. For preparers, this would be a new disclosure for both liabilities and equity, which would require entities to analyse the terms and conditions of each individual financial instrument to determine its priority relative to other financial instruments.

Potential Dilution

52. In practice, users have mixed opinions on what they mean by ‘dilution’. Paragraph 5 of IAS 33 *Earnings per Share* defines dilution as:

> …is a reduction in earnings per share or an increase in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions.

53. However, as identified in our review of user responses (see paragraph 20) , some users interpret dilution as any actual or potential increase in the number of issued ordinary shares regardless of their effect on earnings per share, other than increases that are shared by all (such as stock splits). Some of these users wanted this information to better analyse the potential distribution of returns amongst claims against the entity, how the entity has financed its operations in the past, and how the capital structure might change in the future. In their view, the dilution depicted in IAS 33 only gives part of the picture, because potential ordinary shares are only considered dilutive if they decrease earnings (or increase

loss) per share from continuing operations.[3] Other users wanted this information to better understand how potential voting rights would be distributed amongst claims. As we discussed in paragraph 31, we think information about voting rights is beyond the scope of this project. However, if the Board wishes to provide information about voting rights, it may be convenient to propose supplementing any dilution disclosure with this information.

54. Obligations to issue ordinary shares could be classified as either liability or equity under the Gamma approach. Therefore, potential dilution of ordinary shares can arise from either liability or equity instruments. For example, a liability instrument that is settled with a variable number of shares equal to an amount that is independent of the entity's economic resources gives rise to unlimited dilution potential, an equity instrument such as a fixed-for-fixed warrant gives rise to limited dilution potential (ie the issuance of a fixed number of shares).

55. Ultimately, dilution affects the potential distribution of returns to ordinary shareholders. The presentation approach under Gamma captures some aspects of how other financial instruments affect the distribution of residual returns to ordinary shareholders. However, users also need to know to what extent ordinary shares have been, or will be, diluted by the issuance of additional ordinary shares. This is because users use the information in the financial statements to estimate the potential future returns on their investment in the entity.

56. Currently IAS 33 requires calculation of diluted earnings per share and helps users to assess the potential dilution as at the end of a reporting period. However, as identified in our review of user responses (see paragraph 30) IAS 33 does not require sufficient information to be disclosed on the number of ordinary shares outstanding. Users noted in particular the lack of transparency around the calculation of the weighted average number of ordinary shares. We also noted, during our discussion of the attribution requirements, that IAS 33 has other limitations; in particular, it only considers the effect of equity instruments that are in-the-money. Hence, it is unclear to users how many ordinary shares might be issued if and when some equity instruments switch to in-the-money.

[3] As per paragraph 42 of IAS 33, an entity uses profit or loss from continuing operations attributable to the parent entity as the control number to establish whether potential ordinary shares are dilutive or antidilutive.

57. The existing IAS 33 requires some limited disclosure to support the earnings per share (EPS) calculation, including:

(a) the amounts used as the numerators in calculating basic and diluted EPS, and a reconciliation of those amounts to profit or loss attributable to the parent entity;

(b) the weighted average number of ordinary shares used as the denominators in calculating basic and diluted EPS, and a reconciliation of these denominators to each other;

(c) instruments that could potentially dilute basic EPS in the future, but were not included because they are antidilutive for the period(s) presented.

58. We note the following gaps in the above disclosure requirements:

(a) although paragraph 57(b) above requires a reconciliation of the weighted average number of ordinary shares, there is no disclosure around the total number of ordinary shares outstanding or potentially outstanding at the end of the period;

(b) although paragraph 57(c) above does require some disclosure around instruments that are antidilutive (which include equity instruments that are out-of-the-money in IAS 33), it does not require any specific disclosure about how many ordinary shares could potentially be issued if circumstances change.

59. In order to address the gap in information and user needs in relation to the potential dilution arising from both liabilities and equity, we propose the following objective of disclosure:

> An entity should provide information to help users assess the potential dilution of ordinary shares arising from financial instruments that could be settled by issuing ordinary shares.

60. In relation to the disclosure objective, we define ordinary shares as the class of equity that is the most residual and requires the entity to transfer economic resources only at liquidation for an amount equal to a prorata share of the entity's

net assets on liquidation[4]. We also define dilution as any actual or potential increase in the number of issued ordinary shares.

61. In our view the information to meet the disclosure objective could be provided as follows:

(a) an entity could provide a complete list of all financial instruments that are potential sources of dilution at the end of each reporting period;

(b) In relation to each group of dilutive financial instruments, disclose:

(i) terms and conditions which indicate potential settlement by ordinary shares, including how the number of ordinary shares required for settlement is determined;

(ii) expected dates of share settlement;

(iii) expected number of shares to be delivered, based on the current conditions at the end of reporting period;

(c) a reconciliation of the movement in the number of ordinary shares, and the maximum number of additional potential ordinary shares[5], during the period, including:

(i) the total number of ordinary shares, and additional potential ordinary shares, outstanding at the beginning and end of the reporting period;

(ii) sources of changes in the number of ordinary shares, and additional potential ordinary shares (eg rights issue, stock splits, warrant issues, share repurchases etc.);

(iii) the dates of settlement which lead to changes in the number of ordinary shares;

(iv) the details of any share repurchase plans.

62. For the purposes of this disclosure, we think entities could, but do not have to, use the same grouping as previously used for disclosure on the priority of claims.

[4] This definition is consistent with the definition used for the attribution requirements for equity (as discussed in February 2016).

[5] Assuming the conversion of all financial instruments that require share settlement.

63. Below is an example to illustrate the proposed disclosure requirements above, using the adapted facts and circumstances of Illustrative Example 12 in IAS 33 IE:

Adapted Illustrative Example 12 in IAS 33 IE:

Below are some facts and circumstances in the year 20X1 for Company A.

Ordinary shares: The number of ordinary shares outstanding at the beginning of 20X1 was 5,000,000. On 1 March 20X1, 200,000 ordinary shares were issued for cash.

Convertible bonds: In the last quarter of 20X0, 5 per cent 12,000 convertible bonds with a principal amount of CU12,000,000 due in 20 years were sold for cash at CU1,000 (par). Interest is payable twice a year, on 1 November and 1 May. Each CU1,000 bond is convertible into 40 ordinary shares at the holder's option at any time before maturity. On 1 June 20X1, 2000 bonds were converted.

Convertible preference shares: In the second quarter of 20X0, 800,000 convertible preference shares were issued for assets in a purchase transaction. The quarterly dividend on each convertible preference share is CU0.05, payable at the end of the quarter for shares outstanding at that date. Each preference share is convertible into one ordinary share on holder's call. No preference share has been converted since.

Warrants: Warrants to buy 600,000 ordinary shares at CU55 per share, exercisable at any time within five years were issued on 1 January 20X1. On 1 September 20X1, 400,000 ordinary shares were bought due to exercise of the warrants.

Options: Options to buy 1,500,000 ordinary shares at CU75 per share, exercisable at any time within 10 years were issued on 1 July 20X1. No options were exercised during 20X1 because the exercise price of the options exceeded the market price of the ordinary shares.

Proposed Disclosure as at 31 December 20X1:

The following groups of financial instruments represent potential sources of dilution as at 31 December 20X1:

	Convertible Bonds	**Convertible Preference Shares**	**Warrants**	**Options**
Issue Date	Last quarter of 20X0	Second quarter of 20X0	1 January 20X1	1 July 20X1
Number of potential ordinary shares	480,000	800,000	600,000	1,500,000
Number of Instruments Exercised	80,000	None	400,000	None
Exercise Price	CU1,000 bond par value per 40 shares	Value of preference share	CU55 per share	CU 75 per share
Conversion/exercise Terms	At holder's option			
Exercised by when?	In 20 Years	Indefinitely	In 5 years	In 10 years

The following table shows a reconciliation of changes in the number of ordinary shares outstanding, and maximum additional number of potential ordinary shares that could be outstanding, during the period:

	Actual number of ordinary shares	**Maximum additional number of potential ordinary shares**
1 January 20X1	5,000,000	1,280,000[(1)]
1 January 20X1 Issuance of warrants	-	600,000
1 March 20X1 Issuance of ordinary shares for cash	200,000	-
1 June 20X1 Conversion of bonds	80,000	(80,000) [(2)]
1 July 20X1 Issuance of options	-	1,500,000
1 September 20X1 Exercise of warrants	400,000	(400,000) [(3)]
December 20X1	5,680,000	2,900,000

[(1)] Includes 800,000 from convertible preference shares issued in the second quarter of 20X0, and 480,000 from convertible bonds issued in the last quarter of 20X0.

[(2)] Bonds converted are no longer a source of potential dilution. Therefore the conversion of bonds reduces the maximum number of ordinary shares potentially outstanding.

[(3)] Warrants exercised are no longer a source of potential dilution. Therefore the exercise of warrants reduces the maximum number of ordinary shares potentially outstanding.

Advantages and disadvantages of disclosing information about dilution

64. We note that the proposed disclosure would provide the following benefits for users:

    (a) Provides, in a single place, a summary of all potentially dilutive instruments.

    (b) Information on potential dilution helps users to assess the distribution of returns amongst claims against the entity.

    (c) Responds to the user needs identified for information on potential dilution as in paragraph 22(b). It also gives a full picture of the dilutive aspect of all equity participation, hence meeting the user needs identified as in paragraph 22(c);

65. This would be an additional disclosure. However, we think the proposed disclosure would impose little additional cost on preparers, because most of the relevant information is already required to calculate earnings per share (for entities applying IAS 33), and would be required for the classification and presentation requirements under Gamma. We also think the disclosures proposed could be integrated with other diosclosures:

    (a) IAS 1 already requires disclosure of a reconciliation of changes in the number of ordinary shares outstanding.

    (b) Information about the terms and conditions which indicate potential settlement by ordinary shares could be provided together with other terms and conditions, such as those indicating the priority of the claim (see paragraph 35).

What disclosures do we need to improve users' understanding of the information communicated through classification and presentation

66. In this section we consider what additional information we could provide to complement the information already provided on the **timing** and **amount** features through classification and presentation.

67. This section includes:

(a) Additional disclosures for financial instruments (or components thereof) classified as equity under Gamma (paragraphs 57–69);

(b) Additional disclosures for financial instruments (or components thereof) classified as liabilities under Gamma (paragraphs 70–76).

What additional disclosures do we need for financial instruments (or components thereof) classified as equity under Gamma?

68. In this section we consider what additional information to provide on equity claims to assist with communicating the **timing** and **amount** features, which are already being addressed through classification and presentation requirements.

69. Because under Gamma none of the equity claims require transfer of economic resources prior to liquidation, we think there is no need for additional disclosure on the **timing** feature, except for the share settlement date which has already been addressed in the disclosure on dilutive potential.

70. The **amount** feature is mainly addressed through the attribution requirements. For that purpose, we divided equity claims other than ordinary shares into non-derivative equity claims and derivative equity claims. For non-derivative equity claims (eg non-cumulative preference shares), we proposed that the attribution should follow the existing requirements in IAS 33 *Earnings per Share*, ie allocating to non-derivative equity claims the amount of preference dividends or the excess paid to redeem the equity instruments.

71. For derivative equity claims, we explored four possible approaches to attribution. We omit Approach A from below as it does not require any attribution:

(a) Approach B would attribute an amount equal to changes in the fair value of the derivative; and

(b) Approaches C and D would attribute an amount weighted by the relative fair values of the derivative and of other classes of equity. However, Approaches C and D would require the weighting to be performed in different ways.

72. We note that all three of the above approaches require fair value measurement of derivative equity claims at the beginning and end of a reporting period, and the movement in between. However, because they are based on fair value

measurement, the attribution requirements would reflect the combined effect of multiple features. For example, the fair value of a warrant would reflect a combination of features including the time value of option, strike price, number of shares etc.

73. In relation to derivative equity claims, we think to help users understand the attribution of amounts to such claims, additional information could be provided on the fair value measurement of derivative equity claims, as well as reasons for the change in fair value. Currently such information is not required to be disclosed for equity instruments under IFRS Standards[6]. However, disclosures about fair value would be required under IFRS 7 for instruments classified as liabilities and that were subject to similar risks (such as net cash-settled derivatives on own equity). We also note that some of the user needs identified in paragraph 22(a) indicate a need for fair value information on equity claims.

74. In relation to non-derivative equity claims, we think there is no need to provide additional information. This is because the amount attributed to such claims represents either preference dividend or the excess earned from the redemption of such claims. We think this information is straightforward to understand. Therefore, the disclosure would only apply to derivative equity claims.

75. In order to support the attribution requirement for equity claims, we propose the following objective of disclosure:

> To help users assess the allocation of residual returns by providing information on the fair value measurement for derivative equity claims.

76. In our view the information to meet the disclosure objective could be provided as follows:

For each group of financial instruments that are classified as derivative equity claims:

(a) disclose fair value of the group of financial instruments (or components thereof) at the beginning and end of the reporting period;

[6] IFRS 7 *Financial Instruments: Disclosures* only requires the disclosure of fair value amount for financial assets and financial liabilities.

(b) disclose a reconciliation of the changes in fair value recognised in (a) during the reporting period, including qualitative and quantitative descriptions of the changes in major inputs to the valuation;

(c) provide a description of the valuation techniques, inputs and assumptions used in the fair value measurement.

(d) provide a sensitivity analysis of how the fair value at the end of the reporting period will respond to changes in some of the major inputs to the valuation, if changes in those inputs are expected to be volatile.

77. For the purposes of this disclosure, we think entities could, but do not have to, use the same grouping as previously used for disclosure on the priority of claims.

78. We note that the proposed disclosure would provide the following benefits for users:

(a) Provides additional information to help users understand the factors that affect the allocation of total comprehensive income to various equity classes under Gamma approach;

(b) Responds to the identified user needs for fair value information on equity claims in paragraph 22(a).

(c) Is capable of being integrated with the previous disclosure on the priority of claims and dilutive potential, as they would be both based on the same grouping of financial instruments.

79. We note that the proposed disclosure would entail some costs in collecting the fair value information, as the extent of details would be similar to those for financial assets under IFRS 13 *Fair Value Measurement*. However, we observed that a similar disclosure requirement exists under IFRS 2 *Share-based Payment*, where information is required about how fair value was determined.

What additional disclosures do we need for financial instruments classified as liability under Gamma?

80. In this section we consider what additional information to provide on liability claims to assist with communicating the **timing** and **amount** features, which are already being addressed through classification and presentation requirements. Under Gamma, a liability claim may be settled by cash or shares. As we already

considered liability claims settled by shares in previous sections on priority and dilutive potential, below we only focus on liability claims settled by cash.

81. As the timing of required settlement is prior to liquidation, we think additional information can be provided about the **specific timing** of settlement. We think this information is useful for assessing liquidity.

82. The **amount** feature is further communicated through the separate presentation requirements, by presenting separately liabilities that depend on a residual amount, as well as the income or expense that arises therefrom. We think additional information can be provided about how the settlement amount is determined and the expected amount of cash outflows. We think this information is relevant to Assessment A for assessing the extent of economic resources to meet an entity's obligations as and when they fall due[7].

83. In order to support the classification and separate presentation requirements for liability claims, we propose the following objective of disclosure:

> To help users assess the timing and amount of economic resources required to settle each group of financial instruments classified as liability claims.

84. In our view the information to meet the disclosure objective could be provided as follows:

For each group of financial instruments (or components thereof) classified as liability and that is settled by cash only, disclose:

(a) terms and conditions that are relevant to determining the settlement amount. Such terms and conditions may include principal, interest rate, index etc., if the settlement amount is independent of an entity's economic resources. In other cases, such terms and conditions may specify how the settlement amount varies with changes in the residual amount (or, more directly, changes in the entity's ordinary share price).

[7] We omit the feature of **type** of economic resources, as the scope of this project is financial instruments only. Therefore the only type we are dealing with is cash and other financial assets.

(b) the expected date and amount of cash outflows. Such disclosure may take form of a maturity analysis.

85. Currently IFRS 7 *Financial Instruments: Disclosures* already requires disclosure of a maturity analysis for financial liabilities, which shows the expected amount of cash flows in different time ranges. IFRS 7 also requires disclosures of qualitative and quantitative information about exposure to risks. Hence the disclosure in paragraph 74(b) has already been required, and the only new disclosure required is in paragraph 74(a) about terms and conditions that are relevant to determining the settlement amount, in particular for exposures to the entity's ordinary share price. As under Gamma approach, liabilities that depend on a residual amount have features of equity participation, we think this disclosure on settlement amount meets the user needs identified in paragraph 22(c).

Summary and question for the Board

86. Based on the analysis in this paper, we suggest that the future Discussion Paper includes a discussion of the following potential disclosures:

(a) the priority of claims on liquidation (paragraphs 46–49);

(b) potential dilution of ordinary shares (paragraphs 59–62); and

(c) additional information to support the presentation and classification requirements under the Gamma approach for:

(i) equity instruments (paragraphs 75–77); and

(ii) financial liabilities (paragraphs 83–85).

87. Along with the above, the Discussion Paper should discuss the relationship between the existing disclosures and the potential disclosures. In that respect we note that:

(a) information about the priority of claims on liquidation will be a new disclosure requirement for IFRS Standards;

(b) information about the potential dilution of ordinary shares could be incorporated with existing disclosures on the number of ordinary shares in IAS 1. Some of the information required to prepare the disclosure would already be collected if an entity is applying IAS 33;

(c) information to support the attribution requirements for derivative equity claims raise the quality of information to the same level as the existing liability disclosures for instruments with similar exposures under IFRS 7;

Question for the Board
Does the Board agree with the staff suggestion to include a discussion of the disclosures as proposed in paragraph 86 and 87 in the future discussion paper?