IFRS in Focus

IASB publishes Discussion Paper on Financial Instruments with Characteristics of Equity

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The International Accounting Standards IASB (IASB) has issued Discussion Paper DP/2018/1 *Financial Instruments with Characteristics of Equity*. In this edition of *IFRS in Focus*, we outline the key concepts of the DP.

- The objective of the DP is to analyse how the current requirements in IAS 32 *Financial Instruments: Presentation* could be improved as the application of the Standard has often proved difficult in practice
- The DP defines the basic principles for the classification of financial instruments as either financial liabilities or equity without significantly changing the classification outcomes applying IAS 32
- The IASB's preferred approach identifies a financial liability based on the existence, in the contractual terms of a financial instrument, of a timing feature (i.e. an unavoidable contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation) and/or an amount feature (i.e. an unavoidable contractual obligation for an amount that is independent of the entity's available economic resources)–an equity instrument has neither of these features
- The IASB proposes that for particular financial liabilities and derivatives, income and expenses should be recognised in other comprehensive income (OCI)
- Extensive new presentation and disclosure requirements are proposed to improve the level of information on features of financial liabilities and equity instruments
- The comment period ends on 7 January 2019

Background and objective of the DP

The IASB's DP *Financial Instruments with Characteristics of Equity* addresses issues around the issuer's accounting for financial instruments by proposing new principles for classifying financial instruments as financial liabilities and equity. It also assesses how the presentation and disclosure requirements for those instruments could be improved. This is to provide information that is more useful to investors to understand the features of those financial instruments and their implication on the entity's prospects for future cash flows.

The DP is a result of a research project that was added to the IASB's agenda as a response to comments made during the 2011 Agenda Consultation.

The classification of financial liabilities and equity is of high practical importance and affects all stakeholders, including owners, creditors, rating agencies, preparers, auditors and regulators.

For more information please see the following websites:

www.iasplus.com

www.deloitte.com

In most circumstances, the application of IAS 32 in its current version is not difficult for preparers and, therefore, the IASB's intention is to avoid changes for instruments that have not caused any issues in practice. However, a number of challenges arose over the years, e.g. the accounting for certain obligations that can be settled by the delivery of an entity's own shares or the accounting for instruments that require an entity to repurchase the non-controlling interest shares in a subsidiary in exchange for an amount of cash equal to their fair value, at the option of the holder (also known as 'NCI puts'). The IASB believes that many of these challenges arise because IAS 32 does not always provide a clear rationale for its requirements.

Observation

The issue around the classification of financial liabilities and equity was not part of the IASB's *Conceptual Framework* project. The revised *Conceptual Framework*, published in March 2018, includes a revised definition of liabilities and supporting guidance. However, the equity definition was not reconsidered during the *Framework* project as this would be the focus of the separate research project. Equity is the residual interest in the assets of the entity after deducting all its liabilities. The IASB's preferred approach in the DP would retain that definition.

More information can be found in our *IFRS in Focus* on the revised *Conceptual Framework.*

In addition to the IASB's preferred approach, two alternative approaches to classification are explained in the appendix to the DP. The DP does not contain any proposals to change the scope of IAS 32.

The IASB's preferred approach to classify financial liabilities and equity

An entity would classify a non-derivative financial instrument as a financial liability if it contains either or both of the following features:

(a) An unavoidable contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation[1] (the '**timing feature**')

(b) An unavoidable contractual obligation for an amount that is independent of the entity's available economic resources (the '**amount feature**')

Applying the IASB's preferred approach, equity would continue to be defined as 'the residual interest in the assets of the entity after deducting all of its liabilities'. In other words, an instrument meets the definition of an equity instrument if it is not a liability.

The following table shows the IASB's preferred approach to classify financial liabilities and equity.

Amount feature / **Timing feature**		Unavoidable contractual obligation for an **amount** that is independent of the entity's available economic resources?	
		Yes	No
Unavoidable contractual obligation to transfer cash or another financial asset at a specified **time** other than at liquidation?	Yes	Financial Liability	Financial Liability
	No	Financial Liability	Equity

[1] 'Liquidation' in the sense of the DP does not include a contractually required liquidation as, for example, the liquidation of a limited life entity.

The analysis of the **timing feature** addresses *when* a transfer of economic resources is unavoidable. The timing feature assesses if an entity's available economic resources are sufficient to fulfil its obligations when they are due. Thus, users of financial statements can assess the **demand for economic resources** (i.e. funding liquidity and cash flows) at certain points in time. Examples of those points in time are:

- Due dates of coupons
- Due dates of repayments, e.g. at the maturity date or at different payment dates during the maturity
- Exercise dates for options

The **amount feature** focuses on returns. It analyses if the entity will have sufficient economic resources to fulfil its obligations with regards to the *amount* of the obligations. Hence, when analysing the amount feature, it is important to assess if the amount of the obligation is affected by the availability of economic resources of the issuer (i.e. is the unavoidable contractual amount dependent or independent of the entity's economic resources). The entity's available economic resources are the total recognised and unrecognised assets of the entity that remain after deducting all other recognised and unrecognised claims against the entity (except for the financial instrument in question).

Applying the IASB's preferred approach, an amount is independent of an entity's available economic resources if either of the following applies:

(a) The amount does not change as a result of changes in the entity's available economic resources

(b) The amount changes as a result of changes in the entity's available economic resources but does so in such a way that the amount could exceed the available economic resources of the entity

A simple example would be the repayment of a loan at maturity: the obligation to pay a fixed amount remains independent of the available economic resources of the borrower. In certain cases, the amount of the obligation may change, for example if

- the principal, the interest rate or other payments change with underlying foreign exchange rates, commodity prices or financial assets (e.g. a share index)
- the interest payments are dependent on a benchmark rate (e.g. LIBOR)

If the amount of the obligation changes based on a variable, but independently of the entity's available economic resources, the DP refers to this as an **independent variable**. An example is a bond of a fixed foreign currency amount. The available economic resources of the entity may be affected by the fluctuations of the foreign currency, However, such amounts are independent of the entity's available economic resources because the amount of the bond does not change as a result of the changes in the entity's available economic resources.

An obligation may be independent of the available economic resources of the entity despite the fact that its amount is linked to the entity's economic resources. When the obligation changes on the basis of an entity's available economic resources, but in such a way that the amount of the obligation could be higher than the available economic resources, the obligation is independent of the available economic resources of the entity and the instrument is a financial liability. An example is a financial instrument that is indexed to twice the changes of an entity's recognised and unrecognised net assets, the amount of the financial instrument changes twice as much as the available economic resources of an entity and could hence exceed the available economic resources of the entity. Another example is where the cash flows are linked to a multiple of the issuer's profit. The amount payable may be more or less than the available economic resources of the entity.

Examples of financial instruments that are **not independent** of the available economic resources of an entity are ordinary shares with a right to participate in distributions and to a pro rata share of the net assets at liquidation. The amount feature is dependent on the residual cash flows available after deducting all other recognised and unrecognised claims against the entity. In this case, the conditions for a financial liability are not met and the ordinary shares are an equity instrument of the entity.

Examples of the assessment of the amount feature

Independent	Not independent
• A bond or other obligation for a fixed amount of a particular currency, or an amount based on changes in an underlying variable, such as an interest rate or commodity index • A financial instrument with an obligation for an amount specified by reference to a specific recognised or unrecognised asset the entity controls • A non-redeemable fixed-rate cumulative preference share, with a stated coupon or dividend amount that accumulates in the case of non-payment • A share with a dividend feature that does not accumulate but is reset periodically when not paid	• An ordinary share with a right to participate in distributions and to a pro rata share of net assets at liquidation • A non-redeemable non-cumulative preference share with a stated coupon or dividend amount that is a specified rate of return or a specified amount of cash, but the coupon or dividend amount is cancelled if the coupon is not paid by the entity • An ordinary share in a subsidiary held by a non-controlling interest

Classification of derivative financial instruments

Because of the particular challenges associated with derivatives on own equity (e.g. the "fixed-for-fixed" condition in IAS 32), the IASB developed separate classification principles to apply its preferred approach to derivative financial instruments.

"Fixed-for-fixed" condition in IAS 32

Applying the fixed-for-fixed condition in IAS 32:22, a derivative is classified as equity only if it is settled by exchanging a **fixed amount** of cash or another financial asset for a **fixed number** of the entity's own equity instruments.

Derivative financial instruments contain contractual rights and obligations to exchange underlying financial assets, financial liabilities or equity instruments with another party.[2] Consequently, derivative financial instruments can also be described as exchange contracts that have two 'legs'. For example, in a typical warrant, at the option of the holder, the entity (the issuer) is obliged to deliver its own ordinary shares in exchange for cash. The obligation to deliver shares is one leg (equity leg) and the right to receive cash is the other leg (asset leg). If at least one leg of a derivative involves the delivery or extinguishment of an entity's own equity instruments, or the underlying of a derivative is an entity's own equity, then the derivative is referred to as a derivative on own equity in the DP.

Derivatives on own equity can be unconditional (e.g. forward contracts), or they can be conditional (e.g. options). In addition, derivatives on own equity might be settled in various ways. The settlement of the derivative can be gross physically settled (i.e. settled by exchanging the underlying financial instruments), net-cash settled (i.e. settled net in cash) or net-share settled (i.e. settled net in equity instruments).

[2] This description of derivatives is based on IAS 32:AG15–AG19.

When considering the subject, the IASB considered the following two types of exchanges, which may either be gross physically settled or net-settled in cash or shares:

Asset/equity exchanges	Liability/equity exchanges
Exchange of cash/financial assets for equity instruments	Extinguishment of financial liabilities in exchange for delivery of equity instruments or extinguishment of equity instruments in exchange for a financial liability
Gross physical settlement: Neither the underlying financial assets to be received nor the underlying equity instruments to be delivered are existing financial assets or outstanding equity instruments of the entity. Consequently, gross physical settlement results in an increase in both the entity's assets and equity when they are settled.	**Gross physical settlement:** The financial liabilities or equity instruments that are extinguished on settlement of the derivative are existing financial liabilities or equity instruments of the entity. Consequently, gross physical settlement does not result in an increase of the total amount of financial liabilities and equity when they are settled.

A liability/equity exchange can be a standalone instrument that is a derivative such as a forward purchase or written put over the entity's equity, or could be embedded in a non-derivative financial instrument (host instrument) where the host instrument (a financial liability or equity) is extinguished by the settlement of the derivative. Because of this relationship, in the IASB's preliminary view, an entity should consider the rights and obligations of such derivatives together with those of existing financial instruments that will be, or might be, extinguished. The IASB proposal with respect of the accounting for liability/equity exchange derivatives that extinguish equity instruments is discussed in the section "Compound instruments and redemption obligation arrangements".

Applying the IASB's preferred approach, standalone derivatives on own equity instruments (other than for liability/equity exchange derivatives that extinguish equity instruments) would be classified as equity instruments, financial assets or financial liabilities **in their entirety**. The underlying legs of the instruments would not be separated and classified separately.

A derivative on own equity would be a financial asset or a financial liability if either or both of the following criteria are met:

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

(b) The net amount of the derivative is affected by a variable that is independent of the entity's available economic resources (the **amount feature**)

Classification of those derivatives would be evident if the variables affecting both legs of the derivative would be either all dependent on the entity's available economic resources (equity instrument) or all independent of the entity's available economic resources (financial asset or financial liability). However, the IASB identified many derivatives on own equity that are affected by both types of variables ('**partly independent derivatives**').

The IASB expects that the classification outcome for most derivatives on own equity will remain broadly unchanged compared with IAS 32. However, the classification might change for some derivatives on own equity because of the differences from clarifying the rationale and rearticulating the amount feature. For example, foreign currency rights issues that meet the exemption in IAS 32 and are hence classified as equity would be classified as financial assets or financial liabilities applying the IASB's preferred approach. This is because the net amount is affected by an independent variable (the foreign exchange rate).

Many equity instruments are subject to a potential **dilution** of their share in the available economic resources of the entity. For example, if an entity issues other ordinary shares that have a dilutive effect, it reduces the share of the entity's available economic resources attributable to the holders of existing ordinary shares or derivatives to receive a fixed number of ordinary shares. To prevent this circumstance, many derivatives on own equity include an anti-dilution provision, which adjusts the terms of exchange to keep the derivative holder in the same economic position.

Applying the current requirements in IAS 32, this is assessed using the fixed-for-fixed condition. Analysing the amount feature of the IASB's preferred approach, the entity must assess whether the anti-dilution provision introduces another variable that is independent of the entity's available economic resources. If it does not, the anti-dilution provision in itself is not an independent variable and therefore the anti-dilutive adjustment would not prevent equity classification.

Illustrative classification outcomes applying the IASB's preferred approach and IAS 32

Financial Instrument	Classification outcome applying the IASB's preferred approach	Classification outcome applying IAS 32
Written call option to deliver a fixed number of equity instruments for receipt of a fixed amount of cash in functional currency		
Gross physically settled by exchanging cash for equity instruments	**Equity** (neither an obligation to transfer cash or another financial asset, nor a right to receive cash for the net amount, and net amount of derivative unaffected by a variable independent of the entity's available economic resources)	**Equity** (no contractual obligation to deliver cash or another financial asset and "fixed-for-fixed" condition met)
Settled net in equity instruments	**Equity** (neither an obligation to transfer cash or another financial asset, nor a right to receive cash for the net amount, and net amount of derivative unaffected by a variable independent of the entity's available economic resources)	**Financial liability** ("fixed-for-fixed" condition not met as it is not gross physically settled)
Settled net in cash	**Financial liability** (obligation to transfer cash or another financial asset or right to receive cash for the net amount, but net amount of derivative unaffected by a variable independent of the entity's available economic resources)	**Financial liability** (contractual obligation to deliver cash or another financial asset)

Compound instruments and redemption obligation arrangements

Many of the application issues of IAS 32 arise around the classification of compound instruments that include an embedded derivative (e.g. **convertible bonds**) and obligations to redeem or purchase equity instruments (so-called **puttable instruments**, and, as a subset of those, **NCI puts**). The latter caused diversity in practice as in some cases where the issuer has the choice of settlement it is not clear whether they should be grossed up rather than measured on a net basis like other derivative financial instruments.

The IASB observed that the same contractual rights and obligations of two financial instruments, a non-derivative financial liability and a standalone derivative to extinguish that financial liability in exchange for issuing equity instruments, can be structured as a compound instrument that combines an embedded derivative and a non-derivative financial liability that will be extinguished or converted.

In addition, the IASB observed that liability/equity exchange derivatives with the same settlement outcomes could be structured with two different combinations of contracts:

(a) A financial liability and a derivative that could result in the extinguishment of that financial liability in exchange for delivering own equity instruments

(b) An equity instrument and a derivative that could result in the extinguishment of that equity instrument in exchange for an obligation that meets the definition of a liability

To achieve consistency in classification, in the IASB's preliminary view, the entity would for a standalone derivative to extinguish an equity instrument, consider the package of contractual rights and obligations arising from the derivative and the underlying non-derivative equity instrument that will, or may, be extinguished (together referred to as a 'redemption obligation arrangement'). Once identified, the package of the contractual rights and obligations would then be analysed for classification purposes in a similar way as a compound instrument.

For compound instruments that have equity and liability components, the IASB decided to retain the existing component approach in IAS 32. Applying this approach, the issuer of a non-derivative financial instrument evaluates the terms of the financial instrument to determine whether it contains both a liability and an equity component. Such components would continue to be classified separately as financial liabilities, financial assets or equity instruments.

For a compound instrument or a redemption obligation arrangement, an entity would classify the financial liability and equity components separately. If an entity does not have the unconditional right to avoid a settlement alternative that has the feature(s) of a financial liability, the entity would classify that unavoidable contractual obligation as a non-derivative financial liability. Any remaining rights and obligations would be classified as an equity instrument, a financial asset or a financial liability.

If an entity has the unconditional right to avoid a settlement outcome that has the feature(s) of a financial liability, the instrument does not contain a financial liability component.

If an entity does not have such a right, the entity would identify that unavoidable contractual obligation first and classify it as a financial liability. This is independent of whether the settlement is conditional on rights within the control of the holder or events beyond the control of both the entity and the holder. Any **conditionality** would be included in the derivative representing the remaining rights and obligations and not in the non-derivative financial liability.

Example

An entity issues a convertible bond with an obligation to deliver a variable number (capped at 100) of the entity's own shares with a total value equal to CU100. The cap will be triggered automatically if the share price falls below CU1 per share. Consequently, the entity has an obligation to deliver:

(a) CU100 in shares, if the share price is above CU1

(b) 100 shares, if the share price is below CU1

The entity has an unavoidable obligation to deliver CU100, unless the share price falls below CU1. This conditionality is beyond the control of the entity and consequently, the obligation to pay CU100 would be a **financial liability** because of the amount feature. The entity would not consider the uncertainty that arises from conditionality (i.e. the likelihood of the share price falling below CU1) when identifying the liability component.

After identifying the liability component, any remaining rights and obligations would be classified by applying the derivative classification principle of the IASB's preferred approach.

In the example, the remaining obligation represents an obligation to exchange a financial liability for an equity instrument. The effect of any conditionality in settlement outcomes would be part of the obligation to exchange, i.e. **part of the derivative**.

The consequence of excluding the effect of the conditionality from the financial liability component is that the financial liability recognised would be the same for the obligation arising from a forward contract, for example, a mandatory share repurchase, and for the otherwise identical obligation arising from a written put option on own shares.

Any other alternative settlement outcome arising from a written option would be recognised as a derivative on own equity, which represents a potential exchange of the financial liability for equity instruments.

Redemption obligation arrangements, including NCI forwards and puts, and compound instruments are accounted for consistently when applying the IASB's preferred approach. According to the IASB, this increases information for users of financial statements as both types of instruments have similar contractual rights and obligations that result in a similar classification outcome.

Observation

The accounting for obligations to repurchase the non-controlling interest shares in a subsidiary has been discussed for several years. Following a submission to the IASB's IFRS Interpretations Committee, a project was added to the Committee's agenda to determine how an entity should account for changes in the carrying amount of the financial liability for a written put option over a non-controlling interest. This resulted in a draft Interpretation that was published in May 2012. However, the draft Interpretation was not finalised and instead, the project was reactivated in 2013 as a narrow-scope amendment project of the IASB. In 2014, the project was discontinued as a project in its own right and the IASB decided to consider the issue as part of the research project on *Financial Instruments with Characteristics of Equity*.

The application of the proposed approach to **NCI puts** would be as follows:

(a) Recognition of a liability component at the redemption amount (the subsequent measurement follows IFRS 9)

(b) Derecognition of the NCI on which put options are written, at the fair value of the ordinary shares of the subsidiary at the date the put options are issued

(c) Recognition of the remaining rights, in effect a written call option on the subsidiary's shares (by derecognising the equity instrument at fair value, the amount effectively attributed to the option reflects the value of a similar written call option), as a financial asset or a financial liability or an equity instruments in accordance with the derivative classification principle

The application of this proposal is illustrated in the following example.

Example

An entity issues a written put option on the non-controlling interest of one of its subsidiaries (NCI put) at a strike price of CU110 on 100 ordinary shares of the subsidiary and receives a premium of CU10 for the option. The option is immediately exercisable.

Applying the IASB's preferred approach the accounting would be as follows:

(a) Recognition of a financial liability with a present value of CU110 (strike price of the option)

(b) Derecognition of 100 ordinary shares in NCI at fair value at the date the NCI put is issued

(c) The remaining rights and obligations (the difference between the sum of the amounts (a) and (b), and CU10, the premium received for the written put option) would represent the option of the holder to waive their right to exercise the put and receive CU110 recognised in (a) in exchange for the 100 ordinary shares remaining outstanding

Such an option is similar to a written call option or conversion option in a convertible bond. An entity would classify this component as a financial asset or a financial liability, or an equity instrument in accordance with the derivative classification principle.

Illustrative classification outcomes applying the IASB's preferred approach and IAS 32

Financial Instrument	Classification outcome applying the IASB's preferred approach	Classification outcome applying IAS 32
Compound instrument with a conversion feature that is derivative component		
Bond to transfer a fixed amount of foreign currency in four years' time that is convertible to a fixed number of ordinary shares at the option of the bondholder	**Financial liability classified in its entirety** with income or expense resulting from changes in fair value of foreign currency conversion option potentially presented separately in OCI depending on whether the contract meets the specific criteria (obligation to transfer cash or another financial asset and net amount of derivative affected by a variable independent of the entity's available economic resources and the net amount of the derivative is affected by a foreign currency variable and not by any other variable that is independent of the entity's available economic resources)	**Financial liability classified in its entirety**. Under IFRS 9, an entity can choose to bifurcate the conversion option and measure it at fair value through profit or loss with the bond host contract at amortised cost, or to designate the entire financial instrument as at fair value through profit or loss)
	No **equity component**	No **equity component**
Written option to both: (a) Receive/extinguish/convert a fixed number of ordinary shares (b) Deliver a fixed amount of cash in four years	**Financial liability component** (based on amount feature, as there is an obligation to pay a fixed amount of cash)	Recognise present value of redemption amount (i.e. obligation to pay a fixed amount of cash in four years' time) as a financial liability and reclassify from equity
	Equity component (there is an obligation to exchange a fixed amount of cash for delivering the fixed number of ordinary shares at the option of the holder and any right to discretionary dividend payments for four years)	

Contractual versus non-contractual obligations

The IASB's preliminary view is that an entity applies the IASB's preferred approach to the rights and obligations that arise from the contractual terms of a financial instrument. This includes obligations that are established indirectly through the terms of the contract.

Rights and obligations established by **statutory requirements** imposed by a government are not contractual and should consequently not be considered. The IASB will decide, based on the responses to the DP, if the question as to whether rights and obligations from statutory requirements (e.g. mandatory tender offers or regulatory instruments) should be equivalent to contractual terms needs to be reassessed.

Economic compulsion that could affect the decision of issuers to exercise their rights should not be considered when classifying financial instruments as equity or liabilities. This does not differ from the current accounting practice.

Presentation

In the IASB's preliminary view, to facilitate assessments of balance-sheet solvency and returns, an entity should provide further disaggregated information than currently presented in the statement of financial position and the statement of financial performance[3].

In the **statement of financial position**, financial liabilities and derivatives that contain an obligation for an amount that is independent of an entity's available economic resources should be presented separately from those that do not contain such an obligation.

In addition, financial liabilities and equity should be presented according to the priority of the claim on liquidation. Alternatively, this information can be provided in the notes. If the information in the statement of financial position is presented using a current or non-current presentation, classes of financial liabilities and equity could be arranged by order of priority within those subtotals.

The presentation of **income and expenses** follows the classification of the related items in the statement of financial position. Consequently, equity instruments do not affect the profit and loss account. However, the presentation of income and expenses from financial assets and financial liabilities is dependent on the classification and measurement resulting from the application of IFRS 9.

The IASB considered whether income and expenses from certain financial liabilities should be presented as a separate line item in profit or loss, or as a separate line item in OCI. Those liabilities are:

- Financial liabilities that do not contain an obligation for an amount independent of the entity's available economic resources but are classified as financial liabilities due to their timing feature—a requirement to transfer cash or another financial asset at a specified time other than at liquidation

- Derivative financial assets and liabilities that have net amounts unaffected by any independent variable but are classified as financial assets or financial liabilities due to their timing feature (such as net-cash settled derivatives on own equity)

- Partly independent derivatives—income and expenses that arise from such derivatives would include the effects of changes in the entity's available economic resources in addition to the effects of independent variables

In the IASB's preliminary view an entity should separately present in OCI income and expenses arising from financial liabilities and derivative financial assets and liabilities above as well as from **partly independent derivatives** that meet all of the following criteria:

- The derivative has a net amount that otherwise is unaffected by any other independent variable; the only independent variable is a currency other than the entity's functional currency

- The foreign currency exposure is not leveraged

- The foreign currency exposure does not contain an option feature

- The denomination in the foreign currency is imposed by an external factor—for example, the currency denomination is imposed by law or regulation, or market forces are such that denominating the derivative in the entity's functional currency would not have been practically possible

An entity should not reclassify any of the amounts presented in OCI to profit or loss.

[3] The term 'statement of financial performance', which comprises the income statement and the statement of other comprehensive income, was introduced by the revised *Conceptual Framework* in March 2018.

Statement of changes in equity
The IASB's preliminary view is that the information required by IAS 1 *Presentation of Financial Statements* should be improved by separating equity and the changes in equity into ordinary shares and other equity instruments for presentation purposes. Expanding the attribution of comprehensive income to other equity instruments would enhance information provided about the effects that different features of equity instruments have on the distribution of returns between equity instruments. The allocation of total comprehensive income to non-derivative equity instruments would follow the existing calculation for basic earnings per share in IAS 33 *Earnings per Share.*

As regards the allocation of total comprehensive income to derivative equity instruments, the IASB has discussed three approaches but has not yet formed a preliminary view on which approach to follow.

The following table shows the different approaches for calculating the attribution of total comprehensive income to derivative equity instruments:

	Full fair value approach	**Average-of-period approach**	**End-of-period approach**
Approach for calculating the attribution of total comprehensive income to derivative equity instruments	Attribution based on changes in fair value, with the residual being attributed to ordinary shares	Attribution using relative average fair values through the period	Indirect attribution: calculated by first using relative fair values at the end of the period to attribute the carrying amounts of derivative equity instruments and ordinary shares at the end of the period, then attribution based on the changes in the carrying amounts from one period to another

Disclosures
Users of financial statements have continuously requested more information on equity instruments and the priority of financial liabilities and equity instruments on liquidation. To address these requests, disclosures are to be expanded to include the following:

- Contractual terms and conditions
- Potential dilution of ordinary shares
- Priority on liquidation

In the IASB's preliminary view additional information should be provided about the **terms and conditions** of financial liabilities and equity instruments that affect the amount and timing of cash flows. Such information might include: terms and conditions that are relevant to determining the settlement amount, e.g. principal amount, interest rate, indices and whether and how the settlement amount depends on the entity's available economic resources (such as indexation to share price) and the effect of any options and contingencies. These disclosures should be provided in a single place in the notes to the financial statements.

Given the limitations of IAS 1 and IAS 33, more information about the **potential dilution of ordinary shares** should be provided to meet the needs of users of financial statements. Such information would help users of financial statements understand the distribution of returns to ordinary shares, how the entity has financed its operations in the past, and how the entity's capital structure might change in the future. The disclosures would provide a summary of all potentially dilutive financial instruments and a reconciliation of the movement in the number of ordinary shares outstanding, and in the maximum number of additional potential ordinary shares, during the period. In the IASB's view, these disclosures are a useful addition to the proposed expansion of the statement of changes in equity.

Information about the **priority of financial liabilities and equity instruments on liquidation** would help users of financial statements make more detailed assessments of balance-sheet solvency and returns, for example to determine how any potential surplus or deficit in economic resources and returns will be allocated among claims (typically referred to as the 'waterfall'). The IASB proposes a table to provide a list of all financial liabilities and equity instruments in the order of their priority, unless this information is provided on the face of the statement of financial position.

Observation
In the IASB's view, the implementation of its preliminary views on presentation and disclosure would have a broader effect on entities and users of financial statements than would the implementation of its preliminary views on classification, particularly because very little information is specifically required to be provided about an entity's own equity instruments applying IFRS Standards.

However, information about relevant distinction within liabilities and within equity will help users of financial statements to make better assessments of an entity's prospects for future cash flows.

Alternative approaches to classify financial liabilities and equity
The IASB discussed two more alternatives for the classification of financial liabilities and equity.

Approach A	Approach B
Classification based only on whether there is a contractual obligation to transfer economic resources at a specified time other than at liquidation (i.e. timing feature only)	Classification based only on whether the obligation is for an amount independent of the entity's economic resources (i.e. amount feature only)

Applying Approach A, claims that the entity can settle by transferring other equity claims or claims for which the entity has the unconditional right to defer payment until liquidation, regardless of how the amount of the obligation is determined, would not be classified as liabilities. Applying this approach to derivative financial instruments using the same unit of account as the IASB's preferred approach would result in the classification of net-cash settled derivatives on own equity as financial liabilities, regardless of how any variables might affect the net amount of the derivatives.

In contrast, Approach B would classify claims as liabilities if (and only if) the entity has an obligation for an amount that is independent of the entity's available economic resources, regardless of whether the entity is required to transfer economic resources at a specified time other than at liquidation. Applying this approach to derivative financial instruments would result in the classification of derivatives on own equity as financial liabilities if the net amount is affected by a variable that is independent of the available economic resources of the entity, regardless of the form of settlement.

Next steps

The IASB invites comments on all matters in the DP and, in particular, on the questions set out at the end of each section under 'Questions for respondents'. Comments are to be received by 7 January 2019.

The views expressed in the DP are preliminary and subject to change. The IASB will consider the comments received on the DP before deciding whether to develop an exposure draft with proposals to amend or replace parts of IAS 32. The IASB will discuss possible consequential amendments to other IFRS Standards in more detail if it decides to add a project to amend or replace IAS 32 to its agenda.

In addition, respondents are encouraged to raise other concerns associated with the classification of financial instruments as equity or financial liabilities.

Further information

If you have any questions about financial instruments with characteristics of equity, please speak to your usual Deloitte contact or get in touch with a contact identified in this IFRS in Focus.

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